

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

Northern Illinois Gas Company	:	
d/b/a Nicor Gas Company	:	
	:	
Proposed general Increase in	:	ICC Docket No. 04-0779
rates, and revisions to other terms	:	
and conditions of service	:	

**INITIAL BRIEF OF THE STAFF OF
THE ILLINOIS COMMERCE COMMISSION**

JOHN C. FEELEY
CARMEN L. FOSCO
JOHN J. REICHART
CARLA SCARSELLA
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street, Suite C-800
Chicago, IL 60601
Phone: (312) 793-2877
Fax: (312) 793-1556
jfeeley@icc.state.il.us
cfosco@icc.state.il.us
jreichar@icc.state.il.us
cscarsel@icc.state.il.us

June 22, 2005

*Counsel for the Staff of the
Illinois Commerce Commission*

Table of Contents

	<u>Page</u>
I. INTRODUCTION	1
A. Nature of Operations	3
B. Test Year	3
II. Rate Base	3
A. Uncontested Issues	3
1. Regulatory Tax Liability	3
2. Materials and Supplies Inventory	3
B. Year-End or Average Rate Base Methodology	4
C. Utility Plant Balance	12
D. Accumulated Depreciation (Depreciation Reserve)	14
E. Daily Metering Project	15
F. Mainframe Project	16
G. Gas In Storage	16
1. Staff's Proposed Adjustment	16
2. Accounts Payable Related to Gas in Storage Adjustment	17
H. Pension Asset	17
I. Section 263A	21
J. Deferred Taxes	22
K. Customer Deposits	22
L. Budget Payment Plan	24
M. Uncollectibles Reserve	25
1. Uncollectible Expense Tracker	25
N. Other	33
1. Original Cost Determination	33
III. Expenses	34
A. Uncontested Issues	34
1. Lobbying Expense	34
2. Promotional and Goodwill Activities	34
3. Matching Gift Program	35
4. Injuries and Damages Expense	35

5. PGA and ECR Adjustment	35
B. Depreciation Expense	36
C. Storage Gas Losses	36
D. Industry Association Dues	38
E. Social and Service Club Dues	40
F. Office Supplies Expense	42
G. Branding Expense	42
H. Stock Option Expense	43
I. Incentive Compensation	44
J. Payroll Expense.....	47
K. Payroll Tax.....	48
L. Corporate Benefit Plan Expense	48
M. Interest Expense on Customer Deposits	49
N. Interest Synchronization	49
O. Uncollectibles Expense	49
P. Income Tax Expense.....	50
Q. Rate Case Expense.....	51
R. Gross Revenue Conversion Factor	54
S. Other	54
IV. Weather Normalization	54
V. Rate of Return	57
A. Capital Structure (Inclusion of Short-Term Debt).....	59
1. Nicor Gas' position	59
2. Staff's position.....	60
3. CUB/CCSAO's position.....	61
4. Arguments.....	61
5. Summary.....	67
B. Adjustments to Capital Structure Component Balances	67
1. Nicor Gas' position	67
2. Staff's position.....	68
3. CUB/CCSAO's position.....	68
4. Summary.....	69
C. Cost of Short-Term Debt	69

1. Nicor Gas' position	69
2. Staff's position	69
3. CUB/CCSAO's position	70
4. Arguments	70
D. Cost of Equity	71
1. Nicor Gas witness Malkolm's Analysis	71
a. DCF Analysis	71
b. CAPM Analysis	73
c. Request	74
2. Staff Witness McNally's Analysis	74
a. DCF Analysis	75
b. Risk Premium Analysis	75
c. Recommendation	76
3. Critical Errors in Dr. Makholm's Analysis	78
a. Growth Rates	78
b. Risk Adjustment	81
c. Inconsistencies	82
4. Response to the Company's Criticisms	83
a. Gas Sample	83
b. Growth Rate	87
c. CAPM	88
d. Relative Risk Adjustment	89
e. Assessment of Cost of Equity Estimate	90
E. Flotation Costs	92
F. Overall Cost of Capital	95
VI. COST OF SERVICE, RATE DESIGN, AND TARIFF TERMS AND CONDITIONS	96
A. Cost Of Service Study	96
1. Marginal Cost Of Service Study	96
2. Embedded Cost Of Service Study	98
a. Modified Distribution Mains Study ("MDM Study")	98
b. Coincident Peak (CP) Allocation Methodology	102
c. Average & Peak (A&P) Allocation Methodology	104

B. Rates, Riders, and Other Terms.....	105
1. Rate 5: Seasonal Use Service [uncontested].....	105
2. Rate 75: Seasonal Use Transportation Service [uncontested].....	105
3. Rider 6	105
a. Treatment of Hub Revenues and Expenses	105
(1) Introduction and Statement of Facts.....	105
(2) Hub Revenues.....	106
(3) Hub Costs.....	107
(4) 120 Day Term Limitation on Hub Loans	108
(5) One Year Term Limitation On All Other Hub Transactions.....	109
(6) HUB Firm Services	110
b. Commodity Portion of Uncollectibles	110
c. Commodity Portion of Gas Cost	112
d. Gas Storage Losses (2% Withdrawal Factor)	112
e. Working Capital on Gas Storage	112
4. Rate 1	112
5. Rate 4	115
6. Elimination of Rate 81 – Energy Transportation.....	117
7. Rate 21 – Interruptible Transport and Storage Service	117
8. Rates 74, 76, 77, Riders 15 and 16, and Terms and Conditions.....	117
a. Allocation	117
(1) storage capacity allocation	117
(2) storage withdrawal rights.....	118
(3) daily delivery algorithm/weather sensitivity	118
(4) maximum daily nomination	118
(5) intraday nominations	119
(6) upstream pipeline capacity	119
b. SBS Charge.....	119
c. Cycling	120
(1) Super-pooling	121
d. Level of rate increase.....	121
9. Rider 13 – Group size limitation	126
10. Rider 16 (Customer Select) – Gas Management Issues	126

a.	storage capacity allocation.....	126
b.	storage withdrawal rights	126
c.	daily delivery algorithm/weather sensitivity	126
d.	monthly balancing tolerance/penalty.....	128
e.	access to upstream capacity / elimination of Aggregation Balancing Service Charge	128
11.	Rider 25 – Demand Gas Costs	128
12.	Rider 12 – Environmental Cost Recovery	128
13.	Rider 7 – Local Government Compensation Adjustment	131
14.	Other Customer Select issues.....	133
a.	Billing and gas supply administrative costs.....	133
b.	Mailing list.....	133
c.	Customer Select Signup (Account and Meter Numbers)	133
15.	Energy Efficiency Programs	134
16.	Other (provide rate/rider number).....	134
VII.	CONCLUSION.....	134

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

Northern Illinois Gas Company	:	
d/b/a Nicor Gas Company	:	
	:	
Proposed general Increase in	:	ICC Docket No. 04-0779
rates, and revisions to other terms	:	
and conditions of service	:	

**INITIAL BRIEF OF THE STAFF OF
THE ILLINOIS COMMERCE COMMISSION**

Staff of the Illinois Commerce Commission (“Staff”), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission’s (“Commission”), respectfully submits its Initial Brief in the above-captioned matter.

I. INTRODUCTION¹

In this proceeding, the Commission is investigating the tariffs filed by Northern Illinois Gas Company d/b/a Nicor Gas Company (“Nicor” or “Nicor Gas” or the “Company”) on November 4, 2004, seeking a general increase in gas rates pursuant to Article IX of the Illinois Public Utilities Act (“Act”), (220 ILCS 5/9).

The following witnesses submitted testimony on behalf of Staff: Scott A. Struck (ICC Staff Exhibit 1.0; ICC Staff Exhibit 10.0-Revised), Theresa Ebrey (ICC Staff Exhibit 2.0; ICC Staff Exhibit 11.0-Revised), Leslie Pugh (ICC Staff Exhibit 3.0; ICC Staff

¹ This brief follows the brief outline issued by the Administrative Law Judges (“ALJs”). Although Staff did not take a position on certain issues identified in the brief outline headings, those headings are nevertheless included in this brief so as to fully track the ALJs’ brief outline.

Exhibit 12.0), Thomas L. Griffin (ICC Staff Exhibit 4.0-Corrected; ICC Staff Exhibit 13.0-Corrected), Michael McNally (ICC Staff Exhibit 5.0-Corrected; ICC Staff Exhibit 14.0-Corrected), Mark Maple (ICC Staff Exhibit 6.0; ICC Staff Exhibit 15.0), Mike Luth (ICC Staff Exhibit 7.0; ICC Staff Exhibit 16.0-Revised), David A. Borden (ICC Staff Exhibit 8.0; ICC Staff Exhibit 17.0), and Gene Beyer (ICC Staff Exhibit 9.0; ICC Staff Exhibit 18.0).²

During the course of the proceeding, Staff proposed various adjustments and changes to the Company's November 4, 2004 request. The Company accepted certain of Staff's modifications and Staff withdrew others. A summary of Staff's final recommendations to the Commission in this proceeding is attached hereto as Appendix A.³ As indicated in Appendix A, Schedule 1, p.1, line 5, column e, Nicor's proposed rates reflect a base rate revenue increase of \$61,726,000⁴. (Nicor Gas Exhibit 26B.1,

² For the convenience of the ALJs and the Commission, the preceding citations to Staff's testimony also contain links to the public versions of Staff's testimony contained on the Commission's e-Docket system.

³ Appendix A is based on Staff Exhibit 10.0-Revised, Schedule 10.01-Revised. Staff notes that subsequent to the admittance of Staff Exhibit Schedule 10.01-Revised into evidence, Staff identified a few instances where Schedule 10.01-Revised did not include the correct numbers sponsored by other Staff witnesses. Appendix A attached to this brief reflects the corrected numbers.

⁴ Nicor also proposes to remove from base rates and recover through its Purchased Gas Adjustment Clause ("PGA") rider what it calls the commodity portion of its uncollectible expense. Under Nicor's proposal, approximately \$23 million of uncollectible expenses would be removed from base rates and recovered through its PGA rider – Rate 6, Gas Supply Charge. (Nicor Gas Exhibit 26B.2, Sch. 1.0, p. 1, l. 2, columns C and G) Although the overall effect of Nicor's uncollectible expense proposal is revenue neutral (i.e., when including PGA and base rate impacts), the proposed increase in base rate revenues is roughly \$85,750,000 under Nicor's proposal. (Nicor Gas Exhibit 26B.2, Sch. 1.0, p. 1, l.2, columns F + G). Since Staff's presentation in its testimony and in Appendix 1 is based on Staff's position that PGA recovery of uncollectibles expense is not appropriate and Staff's proposal to continue recovery of
(continued...)

Rev. Sch. C-1, p. 1, I.2, column I) Staff proposes adjustments to Nicor's request totaling approximately \$25,962,000, resulting in a Staff adjusted base rate revenue increase of approximately \$35,764,000 (Appendix A, Schedule 1, p.1, I. 5, column h and I. 26, column i) For the reasons stated below, Staff's proposed adjustments should be adopted by the Commission.

A. Nature of Operations

B. Test Year

II. Rate Base

A. Uncontested Issues

1. Regulatory Tax Liability

Staff witness Ebrey withdrew her adjustment to Regulatory Tax Liability (ICC Staff Exhibit 11.0 Revised, p. 3, II. 53 - 57) in agreement with the Company that the proposed increase to the Regulatory Tax Liability balance would result in an offsetting decrease to Accumulated Deferred Income Taxes and thus would have no net impact on rate base (Nicor Gas Exhibit 26A.0, p. 73, II. 1648 – 1651).

2. Materials and Supplies Inventory

Staff witness Ebrey withdrew her adjustments to Materials and Supplies Inventory and Reserve for Injuries and Damages in the interest of narrowing the issues in this proceeding (ICC Staff Exhibit 11.0 Revised, pp. 3-4, II. 58 - 65).

(continued from previous page)

uncollectibles expense through base rates, Staff will refer to the \$61,726,000 increase rather than the \$83 million increase in this brief.

B. Year-End or Average Rate Base Methodology

Introduction and Statement of Facts⁵

The Commission should accept Staff witness Struck's recommendation to convert the Company's proposed year-end rate base to an average rate base for the test year. An average rate base better matches the level of rate base investment with the revenues and expenses during the test year than does a year-end rate base. In this proceeding, Nicor Gas has selected a future test year. Because of the inherent forward-looking nature of a future test year, it is more appropriate to use an average rate base rather than a year-end rate base. This proposal is consistent with the Commission's practice of using an average rate base with a future test year. (ICC Staff Exhibit 1.0, pp. 6-9, ll. 114-179) The adjustment would produce an average rate base for the test year that is \$40,069,000 lower than the year-end rate base proposed by the Company. (ICC Staff Exhibit 10.08-Revised, p. 1, column (d), l. 23)

⁵ In the January 14, 2005, ALJs' Ruling regarding case procedures, the ALJs indicated as follows:

For each contested issue, initial post-trial briefs must contain a separately labeled statement of facts, with appropriate record citations, and separately labeled argument, with appropriate legal and record citations.

Docket 04-0779, ALJs' Ruling, p. 2 (January 14, 2005). Although Staff has attempted to comply with this directive, most contested issues in this rate case – like most rate cases – are not driven by factual disputes between the parties (i.e., where one party's version of the facts is different from the other's). Rather, most contested issues center on differences of expert opinion based on the application of facts that are typically not contested (e.g., most facts presented by Staff in connection with its positions are obtained from the Company's responses to data requests). Accordingly, many contested issues do not lend themselves to a separate statement of facts or, if one were provided, would unnecessarily lengthen the brief as such supporting facts would need to be repeated in the argument section of the brief to present a cogent argument. Thus, due to the nature of the contested issues in this proceeding, Staff has not presented a separately labeled statement of facts for every contested issue. Staff has provided record citations and case law cites to support its arguments. The structure of Staff's brief was intended to clearly set forth the arguments made by the various parties and responds to said arguments in an easy to follow manner.

An Average Rate Base Better Matches the Test Year

An average rate base better matches the level of rate base investment with the revenues and expenses during the test year than does a year-end rate base. Matching the level of rate base investment with the revenues and expenses during the test year more accurately reflects the cost of providing utility service during the test year. It does so because it matches the components of the revenue requirement formula with one another in a consistent way for the test year. (ICC Staff Exhibit 1.0, p. 7, ll. 128-137; ICC Staff Exhibit 10.0-Revised, p. 14, ll. 250-253)

A Future Test Year is Already Forward-Looking

When deciding whether to use an average rate base or a year-end rate base with a particular test year, the Commission should weigh two important but different and sometimes competing concerns against one another. On the one hand, a year-end rate base can be more forward looking. On the other hand, an average rate base more accurately reflects the cost of providing service for the test year because it better matches the return on rate base during the test year with the other costs incurred during the test year. However, a future test year is based on financial projections and therefore is already forward looking. Accordingly, in terms of weighing the two concerns, it is appropriate to give more weight to the matching concern than to the forward-looking concern in the case of a future test year.

The Commission has previously weighed these two concerns against one another and has given more weight to the forward-looking concern when dealing with

historical test years and more weight to the matching concern when dealing with future test years:

The Commission believes that the question of whether an average or year end rate base should be used in the instant proceeding is a close issue. Although CIPS has presented several well articulated arguments in support of its position, the Commission agrees with Staff that an average rate base should be used. As suggested by Staff, an average rate base generally provides a better matching of test year rate base with operating revenues and expenses, and recent forecast test year rate proceedings have consistently used average rate bases. The Commission also notes that utilities which want to use more forward looking rate bases have the option of making rate filings based on more forward looking test years than those which correspond to the pendency of the proceeding. (Docket No. 90-0072, Order, dated November 28, 1990, pp. 6-7.)

As the Commission noted in its Order in Docket No. 90-0072, it was a close call. However, it is a call the Commission has previously made and one that Illinois utilities have followed. (ICC Staff Exhibit 10.0-Revised, pp. 14-15, ll. 243-275)

It is the Commission's Practice to Use an Average Rate Base with a Future Test Year

The evidence demonstrates that the Commission typically uses an average rate base with a future test year. Staff witness Struck noted that, with a future test year, the Commission found in favor of an average rate base over a year-end rate base in its Order in Docket No. 90-0072. Staff witness Struck further testified that he is unaware of any other cases since Docket No. 90-0072 in which a utility proposed to use a year-end rate base with a future test year. (ICC Staff Exhibit 1.0, pp. 8-9, ll. 151-173) In response to a Company data request, Mr. Struck provided a list of 28 rate cases in which an average rate base was used with a future test year. (ICC Staff Exhibit 10.0-Revised, Attachment A) Therefore, it is the Company's rate base proposal, not Mr. Struck's, that is the unusual one.

Use of an Average Rate Base Would Not Disallow Individual Particular Rate Base Items.

The Company opposed Mr. Struck's recommendation. The Company argued that the use of an average rate base would disallow substantial prudent and reasonable costs that Nicor Gas has incurred or will incur during the test year that are used and useful in order to provide adequate, safe, and reliable tariffed services to customers. (Nicor Gas Exhibit 26A.0, pp. 26-29, ll. 563-643) The Company's argument is incorrect.

The Company confuses rate base methodologies with adjustments to individual rate base components. Since using an average rate base would not disallow particular rate base items, any more than the Company's selection of a 2005 test year over a 2006 test year disallows plant additions for 2006, the Company's argument is incorrect and does not provide a good reason for the Commission to change its practice of using an average rate base with a future test year. Instead, an average rate base is an alternative rate base that, in this case, is more appropriate than the year-end rate base proposed by the Company because an average rate base better matches revenues and expenses throughout the *test year* with the corresponding level of investment throughout the *test year*. (ICC Staff Exhibit 1.0, p.7, ll. 131-137 and ICC Staff Exhibit 10.0-Revised, pp. 6-7, ll. 113-129)

Further, the Company's argument in this rate case contradicts the Company's proposal in its last rate case. In its last rate case, the Company proposed an average rate base with a future test year. This is evidenced by the Commission's Order in Docket No. 95-0219 which states:

Respondent proposes that the rates established in this case be based on the average rate base for the 1996 test-year, i.e., the average of the rate

bases at December 31, 1995, and December 31, 1996. (Order dated April 3, 1996 at 11, Lexis)

There is no indication that the Company intended this to be, or that the Commission understood this to be, a disallowance of prudent and reasonable costs that Nicor Gas had incurred or would incur during the 1996 test year. The selection of one potential rate base methodology over another does not, in and of itself, constitute the disallowance of individual rate base items. (ICC Staff Exhibit 10.0-Revised, pp. 7-8, ll. 129-145)

The Company has Sufficient Flexibility to Present a Forward-looking Rate Case.

The Company has flexibility regarding the timing of when new rates go into effect relative to the test year it chooses. The Company can use this flexibility to present a forward-looking case to the extent it chooses to do so. (ICC Staff Exhibit 10.0-Revised, p. 10, ll. 193-196)

A utility, in preparing a rate case, chooses (i) whether to propose a future or historical test year and (ii) when to file its rate case. The ability to choose both a future test year and the timing of when a rate case is filed, gives the Company flexibility in making its test year forward looking. In the current case, the Company chose both a 2005 future test year and a November 4, 2004 filing date.

Hypothetically, if the Company desired a test year that was more forward looking relative to the date on which its new rates would become effective, then it could have chosen a filing date earlier in 2004 or it could have chosen a filing date two months later and chosen a 2006 future test year. Presumably, the Company weighed its alternatives regarding the type of test year to use and the timing of its filing and made the choices it

thought were best. The fact that the Company made the choices that it did, does not provide a sufficient reason to use a year-end rate base with the chosen future test year. (ICC Staff Exhibit 10.0-Revised, pp. 10-11, ll. 204-223)

The Company notes that if it had made its filing early in 2005, then the Commission's rules would permit the Company to reflect *pro forma* adjustments for plant additions through December 31, 2005. Mr. Struck agreed that this would be the case had the Company made that choice. (Tr., p. 978, ll. 10-18) However, what is more significant is that had the Company chosen a filing date in 2005, then the Company also could have chosen a 2006 future test year. (ICC Staff Exhibit 10.0-Revised, p. 11, ll. 215-219; Tr., p. 958, ll. 6-13) The Company's argument, rather than supporting the Company's use of a year-end rate base, merely highlights the flexibility the Commission has given utilities to make their test years and rate bases forward looking and how Nicor Gas has chosen to use that flexibility in this particular case.

In this case, the Commission should continue to follow its practice of using an average rate base with a future test year. Doing so will better match the level of rate base investment during the future test year with the revenues and expenses during the future test year, chosen by the Company, that is already forward looking. (ICC Staff Exhibit 10.0-Revised, p. 11, ll. 223-227)

The Commission's Rules are Consistent with and Reflect the Commission's Practice of Using an Average Rate Base with a Future Test Year.

The Company argues that 83 Ill. Adm. Code Part 285 ("Part 285") of the Commission's rules do not prohibit a utility from proposing a year-end rate base with a future test year. (Nicor Gas Exhibit 26A.0, pp. 29-30, ll. 644-656) Staff agrees that Part

285 of the Commission's rules does not prohibit utilities from proposing a year-end rate base regardless of the type of test year chosen. However, the rate base a utility proposes is not always the rate base the Commission finds appropriate.⁶ The fact that the Commission's rules do not prohibit Nicor Gas from proposing a year-end rate base with a future test year does not establish that a year-end rate base is appropriate in this case. (ICC Staff Exhibit 10.0-Revised, p. 8, ll. 146-154)

What is more instructive, however, is that Part 285 actually reflects the Commission's practice of using an average rate base with a future test year. If a company chooses a future test year, as Nicor Gas has done in this case, and does not also propose an average rate base with that future test year, Part 285 requires the company to also provide workpapers from which the average rate base for the test year can be determined:

If the rate base components of a future test year are not derived from average data for the test year or from monthly average data, provide work papers supporting Schedule B-1 that reflect the 13 month-end balances of all rate base items commencing with the month-end balance for the month prior to the beginning of the test year and ending with the month-end balance for the last month of the test year. (83 Ill. Adm. Code 285.2005(e))

The Commission requires a company choosing a future test year to also provide information to determine an average rate base, regardless of the rate base the company actually proposes. The Commission's rules do not require this information when a company chooses an historical test year. Thus, while the Commission's rules provide a utility flexibility in presenting its case, the Commission's rules are consistent with and

⁶ For example, see the Commission's Order in Docket No. 90-0072 referenced in Staff witness Struck's direct testimony, ICC Staff Exhibit 1.0, at pp. 8 and 9 and quoted previously in this Initial Brief.

reflect the Commission's practice of using an average rate base with a future test year. (ICC Staff Exhibit 10.0-Revised, pp. 8-9, ll. 155-174)

The Commission Should not Automatically Assume the Company's Year-End Rate Base Would be More Forward Looking than Would the Average Rate Base.

The Company assumes that because the year-end rate base is larger than the average rate base, the year-end rate base will better represent the rate base that will be in place while the rates from this case are in effect. (Nicor Gas Exhibit 26A.0, p. 31, ll. 686-688) However, the Company's history contradicts this assumption.

The year-end rate base the Company proposes in this case is lower than the average rate base the Company proposed 9½ years ago in its last rate case, Docket No. 95-0219. (ICC Staff Exhibit 10.0-Revised, pp. 12-14, ll. 228-242) Even though Nicor Gas has invested roughly \$1.24 billion in capital projects since its last rate case, (Nicor Gas Exhibit 26A.0, p. 24, ll. 518-519) the rate base that the Company itself proposes has declined over the last decade. Thus, the Commission should not automatically assume the Company's net investment in rate base will increase in the coming years, even though it may seem a reasonable assumption at first glance.

Staff's Recommendation in this Case is Consistent with the Commission's Order in CILCO Docket No. 58925.

The Company asserts that the Commission ordered the use of a year-end rate base with a future test year in CILCO Docket No. 58925 ("1974 CILCO Order") (Nicor Gas Exhibit 26A.0, p. 33, ll. 732-734) However, the evidence demonstrates that, although the test year filed in Docket No. 58925 initially used forecasted amounts (Tr., pp. 977-978, ll. 6-1), the Company is incorrect that Docket No. 58925 ("1974 CILCO

case”) used a future test year as defined in the Commission’s current and prior rules. The test year in the 1974 CILCO case is not comparable to the test year the Company chose in this proceeding. Therefore, the Company’s comparison is misplaced. (ICC Staff Exhibit 10.0-Revised, pp. 16-19, ll. 305-377)

Furthermore, prior Commission orders do not form the primary basis for Staff witness Struck’s recommendation regarding rate base methodology. Mr. Struck stated:

I agree that the Commission should base its decision in this Docket upon the evidence in this Docket. I indicated this to the Company in response to Nicor Data Request SAS-2.10. My recommendation in this Docket is based upon the evidence in this Docket. It is not my position that prior Commission Orders preclude the Commission from reaching a different conclusion in this Docket. The basis for my recommendation is that an average rate base better matches the level of rate base investment with the revenues and expenses through out the test year than does a year-end rate base. That, coupled with the fact that the Company chose a future test year which is forward looking, leads me to recommend that the Commission use an average rate base in this proceeding. I refer to prior Commission orders to show that my recommendation and the basis for it are reasonable in that they are consistent with the Commission’s prior practice. (ICC Staff Exhibit 10.0-Revised, pp. 19-20, ll. 381-393)

C. Utility Plant Balance

The Commission should accept Staff witness Tom Griffin’s recommendation to adjust the Company’s forecasted Capital Expenditures. Staff witness Griffin proposed to reduce the Company’s forecasted Capital Expenditures for the years 2004 and 2005 by 3.3%. (ICC Staff Exhibit 4.0, pp. 3-4, ll. 47-68 and ICC Staff Exhibit 13.0, pp. 2-4, ll. 20-67). Mr. Griffin’s methodology for determining his adjustment was to randomly select the years 1998-2003 and compare the actual Capital Expenditures with budgeted Capital Expenditures for that randomly selected period (Staff Exhibit 4.0, Schedule 4.01, p. 3). His analysis shows that the Company’s actual Capital Expenditures historically

vary from budget by unpredictable and volatile amounts with no discernable pattern. The variance during the period analyzed by Mr. Griffin ranged from -17.5% to +8.0%. Mr. Griffin testified that for ratemaking purposes it is appropriate to adjust the Company's forecasted Capital Expenditures by the average variance to budget. Additional evidence in the record supporting Mr. Griffin's adjustment came in during his cross examination. Under cross-examination, Mr. Griffin pointed out that preliminary 2004 Capital Expenditure results are 3.4% lower than the Company's 2004 forecast. (Tr., p. 1103, l. 12 and Tr., p. 1107, l. 10)

The Company disagrees with Mr. Griffin's adjustment (Nicor Gas Exhibit 22.0, pp. 1-4; Nicor Gas Exhibit 26B.0, pp. 35-38) because it contends that the adjustment is not forward looking. However, Mr. Griffin's adjustment is forward looking. Mr. Griffin explained that it is appropriate to look at historical information to predict what is likely to occur. Furthermore, Mr. Griffin explained that he does not disagree with the procedure used by Nicor Gas for forecasting capital expenditures. (ICC Staff Exhibit 13.0, pp. 2-4, ll. 20-67) Actual capital expenditures, as the Company acknowledged, will vary from budgeted expenditures from year to year to some extent. (Nicor Gas Exhibit 22.0, p. 2, ll. 37-39) The purpose of Mr. Griffin's adjustment is to account for the average of this variance based upon past performance.

The Company also argues that several permutations of Mr. Griffin's adjustment are possible and that he selected the one that yielded the most significant adverse result. (Nicor Gas Exhibit 26B.0, p. 36, ll. 808-811) While Mr. Griffin agreed that several permutations of his adjustment are possible, he disagreed that he selected the most adverse one and provided examples of other possible permutations that would have

been even more adverse to the Company. (ICC Staff Exhibit 13.0, pp. 3-4, ll. 51-67) Mr. Griffin's adjustment is appropriate for ratemaking purposes and should be adopted.

The witness for the People of the State of Illinois, David J. Effron, also recognized that the Company's forecasts for capital expenditures have been historically inaccurate for setting rates and has proposed adjustments to the forecasts for the years 2004 and 2005. Mr. Effron proposed using the preliminary actual capital additions for 2004 and using the average capital additions for 2002 and 2003 as a substitute for the 2005 forecasted additions. Mr. Effron also proposed adjustments for the related effects upon accumulated depreciation and depreciation expense. Staff agrees with Mr. Effron that the Company's capital budget forecasts are unreliable for rate making purposes. However, Staff recommends that the Commission use Mr. Griffin's method to adjust the 2004 and 2005 forecasts. Mr. Griffin's method is more appropriate because it calculates the average historical difference between actual capital expenditures and the Company's forecasts.

D. Accumulated Depreciation (Depreciation Reserve)

Mr. Griffin is recommending an adjustment to Accumulated Depreciation relating to his proposed Utility Plant Adjustments (Staff Exhibit 13.0, Schedule 13.01). While Mr. Griffin's adjustments to Utility Plant are contested, his proposed adjustments to Accumulated Depreciation related to those adjustments are not contested.

E. Daily Metering Project

Staff witness Thomas L. Griffin is recommending reducing the cost of the Company's Daily Metering Project for rate making purposes by \$389,000, the amount by which the Company exceeded its authorized expenditure for the project. (ICC Staff Exhibit 4.0, pp. 4-6, ll. 69-106 and ICC Staff Exhibit 13.0, pp. 4-5, ll. 68-85). The Company's internal written policy, Policy Order A-11, Control of Capital Expenditures, sets conditions under which capital projects require authorization from the Company's Capital Management Team. The policy helps to assure that the cost associated with major projects are prudent. Article VIII of the policy states:

Actual (Emphasis added) expenditures for each project that exceed \$250,000 shall be reviewed by the department responsible for performing the work or administering the contract. Revisions to authorizations shall be requested when the cost to continue a project differs from the last authorized amount by + or - \$200,000 or more, a revision to the authorization is required regardless of the percentage.

The actual cost of the Daily Metering Project exceeded the authorized amount by \$389,000. That fact is undisputed. The Company's Capital Expenditure Control Policy required that the additional \$389,000 cost receive a revised authorization. However, the policy was not followed. The Company argues that its capital project costs typically refer to direct costs only and that overhead costs are not included in a capital project's capital authorization. (Nicor Gas Exhibit 23.0, p. 2) While that may have become the Company's practice, such a practice did not comply with the written policy. The policy is clear. The policy refers to "actual" costs. Actual costs include both direct and overhead costs. The fact that, in practice, the Company is violating its own cost controls is no reason for the Commission to ignore the Company's own cost controls. To assure that

only prudent costs are included for rate making purposes, Staff's adjustment must be accepted.

F. Mainframe Project

Staff witness Thomas L. Griffin recommends reducing the cost of the Company's Mainframe Project to account for an early purchase discount in the amount of \$522,000 received by the Company (ICC Staff Exhibit 4.0, p.6, ll. 107-113 and ICC Staff Exhibit 13.0, pp. 5-6, ll.86-98). The fact that the Company received the discount is undisputed. The Company contends that since the cost of the Mainframe Project included in the Company's filing is part of a forecast, the forecast should be considered as a whole (Nicor Gas Exhibit 23.0, pp. 3-4). However, the mainframe project is one of the major projects identified in the Company's filing as projects added to the rate base since the last rate case (see F Schedules). It is appropriate to make this adjustment.

G. Gas In Storage

1. Staff's Proposed Adjustment

In direct testimony, Staff witness Maple proposed a reduction to the Company's proposed working capital allowance for gas in storage that resulted in a \$44,712,418 corresponding reduction to rate base. (ICC Staff Exhibit 6.0 p.3) Subsequently, in his rebuttal testimony, Mr. Maple withdrew his adjustment in response to new information provided by Nicor in its rebuttal testimony. (ICC Staff Exhibit 15.0, p. 1) Staff now accepts the Company's proposed working capital allowance for gas in storage as set

forth in the Company's initial filing and the rebuttal testimony of Messrs. Bartlett and Gorenz. (Nicor Gas Exhibit 24.0, pp. 2-5) (Nicor Gas Exhibit 26.0B, pp. 43-45)

Additionally, Mr. Maple proposed that the Commission include in the final order a requirement that Nicor abide by the following language regarding future leased storage management contracts:

Prior to its entering into any agreement with a third party for the management of leased storage which would reduce the volume of gas in inventory held by Nicor Gas, the Company must provide Staff with a copy of the analysis used by the Company establishing the benefits of entering into such an agreement.

Nicor indicated in its response to Staff data request ENG 7.07 that the Company found this language to be acceptable. (ICC Staff Exhibit 15.0, p. 4)

2. Accounts Payable Related to Gas in Storage Adjustment

Since Staff witness Mark Maple has withdrawn his gas in storage adjustment (ICC Staff Exhibit 15.0, p. 1, ll. 16-18), Staff witness Ebrey's companion adjustment to Accounts Payable associated with Gas in Storage was also withdrawn (ICC Staff Exhibit 11.0 Revised, p. 3, ll. 49 – 52).

H. Pension Asset

Staff witness Pugh proposed an adjustment to reduce rate base by a net amount of (\$105,410,000) to disallow what, for regulatory purposes, represents an over accrual of pension credits. The net amount consists of a (\$184,192,000) pension asset less \$78,782,000 of related accumulated deferred income taxes ("ADIT"). (ICC Staff Exhibit 3.0, pp. 2-3, ll. 38-55 and ICC Staff Exhibit 12.0, p. 4, ll. 66-70) The pension asset results from changes in actuarial pension assumptions used by Nicor and returns on

trust assets in excess of those assumed on the funds provided by ratepayers for the trust assets. The trust funds now generate returns and net gains, both of which more than offset the cost of annual pension benefits earned by employees in a given year. Since the pension asset was created by ratepayer-supplied funds rather than shareholder-supplied funds, the shareholders should not be able to earn a return on the prepaid pension asset.

It is astonishing that Nicor is proposing to include the pension asset in rate base. Staff witness Pugh's proposed adjustment is consistent with the Commission's finding in Nicor Gas' last rate order where the Commission stated:

[T]he Commission finds that the proposal to eliminate the net Pension Asset from rate base is consistent with past Commission orders which found that the overfunded pension asset was created from ratepayer-supplied funds. The Commission adopts Staff's recommendation to eliminate a net \$39,798,000 from the test-year rate base, which reflects the difference between the Pension Asset adjustment and the related ADIT adjustment. The Commission also rejects NI-Gas' arguments in briefs that the adjustment constitutes retroactive and single-issue ratemaking. Staff's approach is not retroactive ratemaking because it is not an attempt to correct for a past error or omission, rather the adjustment disallows, on a prospective basis, an asset that NI-Gas proposed to include in test-year rate base for the first time. Similarly, Staff's approach is not single-issue ratemaking because Staff evaluated all rate base components, including the pension asset, in the aggregate on the same basis. In addition, NI-Gas also proposes to remove either the OPEB deduction from rate base or the pension credit from operating expense. These proposals are rejected. NI-Gas continues to control the ratepayer-supplied OPEB funds, and the pension credit is an item that NI-Gas will realize in the test year.

(Order dated April 3, 1996, Docket No. 95-0219, pp. 9-10) The Company acknowledged that due to the funded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003 (Nicor Gas Exhibit 26A.0, p. 56, ll. 1266-1267). The record is clear that the situation has not changed since the Commission's last rate order.

Company witness O'Connor opposed the disallowance of the net pension asset for the following reasons:

1. The proposal to disallow the net pension asset is not valid because the rates set in the last rate case included an annual pension credit to ratepayers and the rates proposed in this direct case includes an annual pension credit;
2. Staff witness Pugh's reasoning that ratepayers funded the pension asset is not correct; and,
3. The payments made into the pension trust were made by Nicor Gas, not customers. (Nicor Gas Exhibit 26A.0, pp. 54-57, ll. 1219-1279)

The Company's assertions are incorrect. First, contrary to the Company's assertion, Ms. Pugh's adjustment is clearly valid. On page 9 of the Order in the Company's previous rate case, Docket No. 95-0219, the Commission concluded that the overfunded asset was created from ratepayer-supplied funds. Further, the Company acknowledged that due to the funded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003 (Nicor Gas Exhibit 26A.0, p. 56, ll. 1266-1267). Since the pension asset results from overfunding by ratepayers and healthy pension fund earnings, the Company has been allowed to record a negative pension expense since the previous rate case. This negative pension expense (credit) should be passed through to benefit ratepayers because it is the calculated projected net periodic benefit cost (credit) for the 2005 test year. Rates are based upon the Company's projected needs during the time in which the rates set in this proceeding will be in effect. The Company argued including the annual pension

credit in operating expenses is unwarranted and unjust. (Nicor Gas Exhibit 26A.0, p. 60, l. 1340) However, ratepayers should not be denied the credit for the previous overpayment for pension expense, which they funded. For the preceding reasons, ratepayers are entitled to the benefit of the credit and my proposed adjustment is valid.

Second, the Company is also incorrect that ratepayers have not funded the pension asset. The Company acknowledged that due to the funded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003. (Nicor Gas Exhibit 26A.0, p. 56, ll. 1266-1267) Also, the Company argued that the payments made into the pension trust were made by Nicor Gas, not customers. (Nicor Gas Exhibit 26A.0, p. 55, ll. 1243-1244) However, the Company fails to consider that prior to the 1987 rate case there was a positive pension expense that was included in the cost of service. (Docket No. 95-0219, Order dated April 3, 1996, p. 8) That positive expense was included in customer rates resulting in the customers funding the pension asset, not Nicor Gas. Nicor Gas may have written the check to the trust, but the funding was made by the customers. Since the overfunded pension asset was created by ratepayer-supplied funds, the shareholders should not be able to earn a return on the prepaid pension asset. Just as the shareholders should not benefit by earning a return on over-accrued assets, which they did not provide, so should they not be penalized by having the related deferred income taxes deducted from rate base.

AG witness Effron also proposed an adjustment to reduce Retirement Benefits, Net by \$186,882,000 and the related accumulated deferred income taxes by \$79,919,000 for a net reduction to the Company's rate base of \$106,963,000. Further, he eliminated the prepaid pension asset from rate base to be consistent with the

Commission's findings in Docket No. 95-0219. (AG Exhibit 1.0, p. 11, ll. 1-11) AG witness Efron's adjustment is different from Staff's from the aspect that he adjusts the year-end amounts and Staff's adjustment is based on average rate base amounts.

The Commission should accept Staff's adjustment to reduce rate base by a net amount of (\$105,410,000), which includes the pension asset of (\$184,192,000) and the related ADIT of \$78,782,000.

I. Section 263A

Staff witness Ebrey proposed an adjustment to increase the Company's ADIT to reflect the required proration and the revised Internal Revenue Code Section 263A ("Section 263A") adjustment proposed by the Company (ICC Staff Exhibit 2.0, p. 9, ll. 168-170 and ICC Staff Exhibit 11.0 Revised, p. 2, ll. 21-27).

AG witness Efron's proposed adjustment to ADIT discounts the Section 263A election as being "entirely speculative" (People of the State of Illinois' Pretrial Memorandum, p. 5), however, the evidence in the record, including AG Cross Exhibit 13, indicates the Company's adjustment is reasonable for purposes of a future test year. Company witness O'Connor agreed with Staff that the prorated balance of deferred tax on property should be \$18,214,000 (Nicor Gas Exhibit 26A.0, p. 68, ll. 1537 – 1539).

The Commission should approve the ADIT proposed by the Company of \$345,956,000 (\$327,742,000 (Nicor Part 285 filing, Schedule B-1) + \$18,214,000 (see above paragraph)) since it is a reasonable estimate of the future test year ADIT balance.

J. Deferred Taxes

Staff witness Griffin's recommends adjustments to deferred taxes based on his adjustments to utility plant. (Staff Exhibit 13.0, Schedule 13.02) While Mr. Griffin's adjustments to utility plant are contested, his proposed adjustments to deferred taxes related to those adjustments are not contested.

AG witness Efron proposed an adjustment to decrease ADIT by \$726,000 to reflect the actual ADIT balance as of December 31, 2004 (AG Exhibit 1.0, Schedule B-3). The Company's only rebuttal to this adjustment is its characterization of the adjustment as a "selective update" (Nicor Gas Exhibit 26A.0, p. 69, ll. 1562 – 1563). If the Commission finds that refining forecasts as actual balances become known is superior to the Company's forecasted balances based on 2 year old data, the AG's adjustment reducing ADIT based on the actual December 31, 2004 balance should be approved.

K. Customer Deposits

The Company forecasted Customer Deposits of \$23,711,000 as a reduction to rate base. (Nicor's Pretrial Memorandum, p. 26) This forecasted December 2005 balance was equal to the Company's December 2003 balance for Customer Deposits. (Nicor Part 285 filing, Schedule B-13).

Staff proposed an adjustment to Customer Deposits averaging the actual 13 monthly balances, December 2003 through December 2004 (ICC Staff Exhibit 2.0, Schedule 2.03). Staff subsequently withdrew its adjustment while still maintaining that using actual balances as they are available for projections is superior to the Company's use of 21 months of projected balances. (ICC Staff Exhibit 11.0, p. 4, ll. 62-64)

However, Staff never agreed with the Company's forecasted balance as the Company stated in its Pretrial Memorandum. (Nicor Pretrial Memorandum, p. 26) Staff simply withdrew its adjustment in an effort to narrow the issues. While both Staff and the AG proposed adjustments, the methodology of those adjustments was different. Consistent with Staff witness Ebrey's statement during cross examination with respect to the Budget Payment Plan, if the Commission agrees that it is appropriate to update the forecast for actual balances, the AG's adjustment is a reasonable alternative to the Company's projections.

AG witness Efron likewise updated the projections for actual balances basing his adjusted Customer Deposits on the actual December 2004 balance (AG Exhibit 1, p. 15, ll.14-15). The Company's only rebuttal to Staff's initial adjustment or AG witness Efron's adjustment to Customer Deposits is that it does not agree to make what it calls "selective updates" to rate base components (Nicor Gas Exhibit 26A.0, p. 69, ll. 1568 – 1569). Mr. Efron disagrees with the Company's characterization of the adjustment as a "selective update" but rather avers that the Company's method of forecasting is faulty and his correction of that faulty method does not constitute a selective update (AG Exhibit 1.3, p. 14, ll. 17 – 19).

Staff does not take issue with the Company's proposal for Customer Deposits, however, should the Commission find that updates to the Company's projections are appropriate; the adjustment proposed by the AG's witness would be a reasonable alternative.

L. Budget Payment Plan

The Company forecasted a Budget Payment Plan balance of \$60,965,000 based on actual monthly balances through March 2004 and projections for the next 21 months (Nicor Part 285 filing, Schedule B-14).

Staff proposed an adjustment to Budget Payment Plan balances averaging actual 13 monthly balances, December 2003 through December 2004 (ICC Staff Exhibit 2.0, Schedule 2.04). Staff subsequently withdrew its adjustment while still maintaining that using actual balances as they are available for projections is superior to the Company's use of 21 months of projected balances. (ICC Staff Exhibit 11.0 Revised, p. 4, ll. 60-64) Staff withdrew its adjustment in an effort to narrow the issues in this proceeding. (ICC Staff Exhibit 11.0 Revised, p. 4, ll. 64-65) While both Staff and the AG proposed adjustments, the methodology of those adjustments was different. Staff witness Ebrey stated during cross that should the Commission agree that it is appropriate to update the forecast for actual balances, the AG's adjustment is a reasonable alternative to the Company's projections (Tr., p. 862).

AG witness Effron likewise updated the projections for actual balances basing his adjusted Budget Payment Plan balance on the 13 month average of actual monthly balances through March 2005⁷ (AG Exhibit 1.3, Schedule B-4), claiming that actual balances in 2004 appear to be more typical of the Company's experience than the balances projected by the Company. The Company, in rebuttal testimony, stated that it does not agree such updated projections were representative of the typical or expected

⁷ While the balances appear to be the projections through December 2005 on AG Exhibit 1.3, Schedule B-4, the projected April through December 2005 amounts are the same as actual April through December 2004 as shown on the Response to AG data request 1.25.

balances and that it does not agree to make what it calls “selective updates” to rate base components (Nicor Gas Exhibit 26A.0, p. 70, ll. 1573 – 1577).

Staff does not take issue with the Company’s proposal for Budget Payment Plan Balances, however, should the Commission find that updates to the Company’s projections are appropriate; the adjustment proposed by the AG’s witness would be a reasonable alternative.

M. Uncollectibles Reserve

Staff witness Struck recommends the Commission reject the adjustment proposed by Citizens Utility Board and Cook County States Attorney’s Office witness Mierzwa to reduce the Company’s rate base by the balance of the reserve for uncollectible accounts. The uncollectible reserve does not represent a ratepayer-supplied source of funds because of the way uncollectibles expense is matched to sales by accrual accounting. (ICC Staff Exhibit 10.0-Revised, pp. 25-26, ll. 501-516) Mr. Mierzwa’s proposed adjustment would improperly reduce the Company’s rate base by \$24,185,247 resulting in a reduction of the Company’s revenue requirement by approximately \$3,806,494. (CUB-CCSAO Exhibit 2.2)

1. Uncollectible Expense Tracker

Introduction and Statement of Facts

The Commission should reject the Company’s proposal to recover the commodity-related portion of its uncollectibles expense through the Purchased Gas Adjustment Clause (“PGA”). The PGA is for the limited purpose of changing rates based upon changes in the cost of purchased gas. (ICC Staff Exhibit 1.0, pp. 16-18, ll. 311-388) Uncollectibles expense is not a cost of gas and therefore should not be passed

through the PGA. (ICC Staff Exhibit 1.0, pp. 13-15, ll. 254-310) Furthermore, Nicor Gas's uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider. Therefore, Nicor Gas' uncollectibles expense should not be separated out from other test year operating expenses to be given special treatment through the PGA. (ICC Staff Exhibit 1.0, pp. 18-26, ll. 389-503) Consistent with this recommendation, Staff witness Struck reversed the Company's proposed adjustment to remove \$23,417,000 of uncollectibles expense from the test year. (ICC Staff Exhibit 10.0-Revised, Schedule 10.09-Revised)

If the Commission does accept the Company's proposal to recover the commodity-related portion of uncollectibles expense through the PGA, then the Commission should reject that part of the proposal that provides that the 66.6% allocation of uncollectibles to the PGA would never be subject to change. (ICC Staff Exhibit 1.0, p. 26, ll. 504-517; ICC Staff Exhibit 10.0-Revised, pp. 25-26, ll. 501-516) Furthermore, if the Commission determines that the commodity-related portion of uncollectibles expense should be recovered through the PGA, then the Commission should initiate a rulemaking to revise 83 Ill. Adm. Code Part 525 ("Part 525") accordingly. (ICC Staff Exhibit 1.0, pp. 26-27, ll. 504-530)

Uncollectibles Expense is not a Cost of Gas

Quite simply, uncollectibles expense is not an unrecovered cost of gas. Rather, uncollectibles expense is a cost of doing business on something other than a cash-only basis. The Company recovers the cost of gas when it sells the gas and obtains a binding obligation on the part of the customer to pay. The sale is an exchange of the

gas for something else of value, usually an account receivable. This exchange is the basis for recognizing the sale. If another economic event, separate from and subsequent to the sale, reduces or eliminates the value of the receivable, it does not change the fact that the exchange occurred and that the receivable had value at the time of the exchange. (ICC Staff Exhibit 1.0, p. 14, ll. 275-286) This not only reflects the economic reality of these transactions (Tr., p. 989, ll. 1-18), it is also consistent with the Commission's Uniform System of Accounts (ICC Staff Exhibit 1.0, p. 15, ll. 300-310), Part 525 (ICC Staff Exhibit 10.0-Revised, pp. 21-22, ll. 412-425), Generally Accepted Accounting Principles (Tr., pp. 987-988, ll. 16-7), and the way in which the Company has filed and the Commission has approved the Company's annual PGA reconciliations (ICC Staff Exhibit 10.0-Revised., p. 22, ll. 426-438).

Nicor Gas' Uncollectibles Expense Does Not Warrant Special Treatment through a Rider

Nicor Gas' uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment. Therefore, Nicor Gas' uncollectibles expense should not be separated out from other test year operating expenses to be given special treatment through a rider like the PGA. (ICC Staff Exhibit 1.0, pp. 18-26, ll. 389-503)

The evidence demonstrates Nicor Gas's uncollectibles expense is not a significant expense when compared to Nicor Gas' other operating expenses, excluding purchased gas costs. (ICC Staff Exhibit 1.0, p. 19, ll. 401-421) Figure 1 compares Nicor Gas' uncollectibles expense with the total of all other operating expenses, excluding purchased gas costs. (ICC Staff Exhibit 1.0, p. 20)

Figure 1
Uncollectibles Compared to All Other Expense (Excluding Gas Costs)

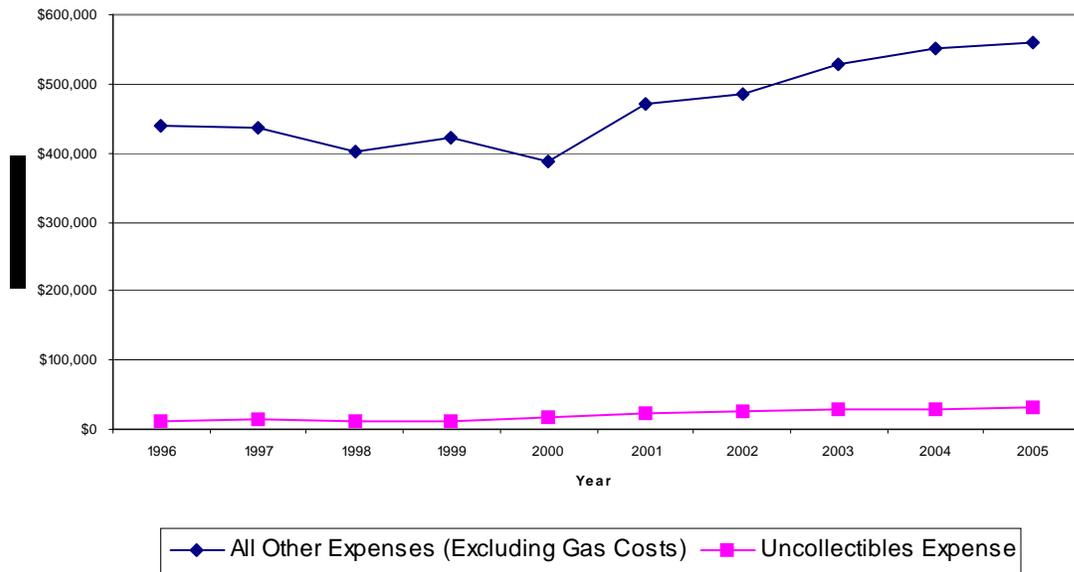


Figure 1 demonstrates that Nicor Gas’s uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider like the PGA.

The evidence also demonstrates Nicor Gas’ uncollectibles expense has not been fluctuating more than the other expenses. Figure 2 demonstrates that the magnitude of change in other expenses, excluding purchased gas costs, has been greater than the magnitude of change in uncollectibles expense. (ICC Staff Exhibit 1.0, p. 21)

Figure 2
Change in Uncollectibles Compared to Change in All Other Expenses (Excluding Gas Costs)

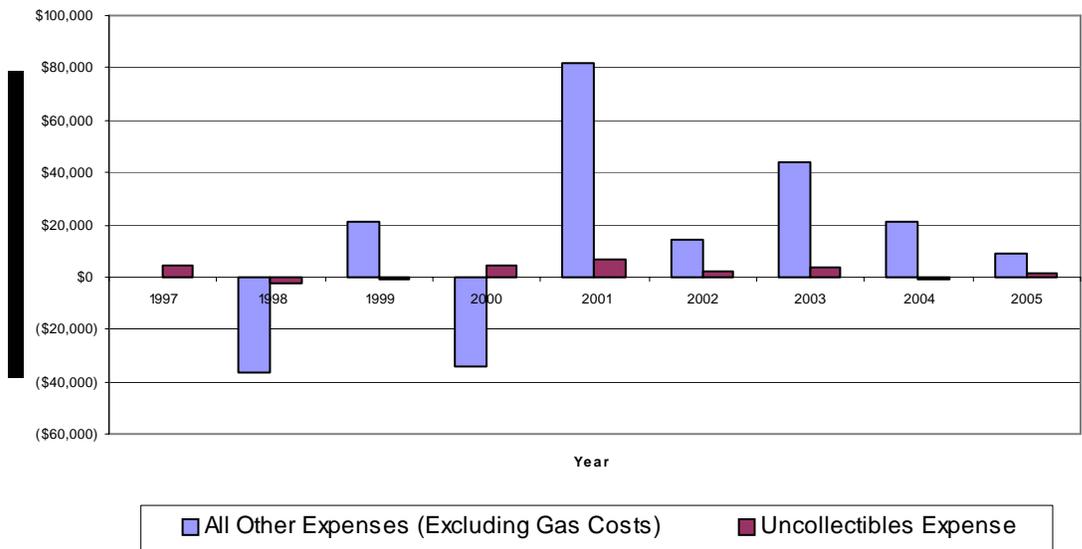
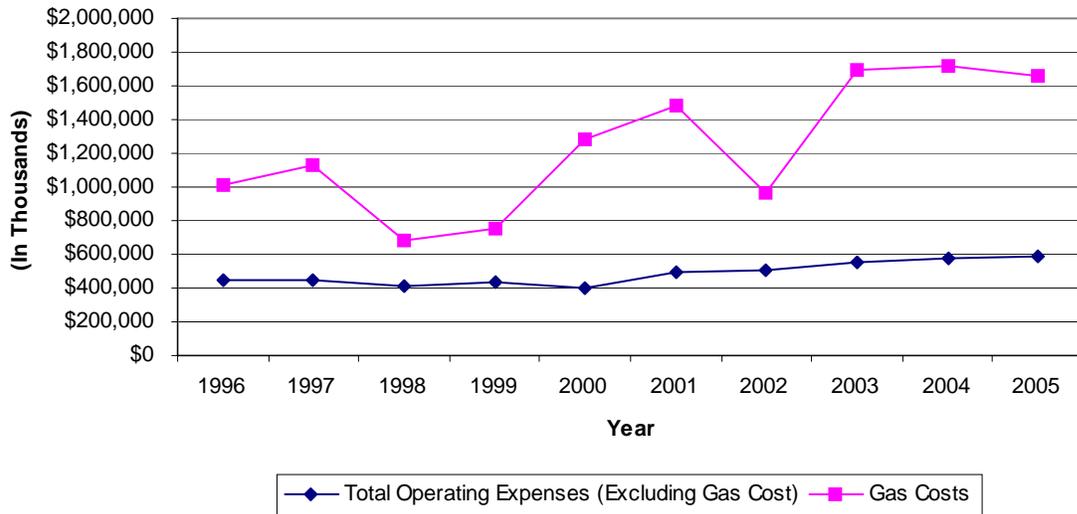


Figure 2 demonstrates that Nicor Gas' uncollectibles expense does not fluctuate significantly in comparison to the overall operating expenses in a way that warrants special treatment through a rider like the PGA.

By way of comparison, purchased gas costs both stand out and fluctuate significantly in comparison to other operating expenses. Figure 3 compares Nicor Gas' purchased gas costs with the total of all its other operating expenses for the years 1996 through the 2005 test year. (ICC Staff Exhibit 1.0, p. 22)

**Figure 3
Gas Costs Compared to All Other Expenses**



This is one of the reasons a rider, the PGA, is warranted for purchased gas costs. The Commission noted this when revising Part 525:

The purpose of this proceeding is to revise Part 525 which is the tracking mechanism designed to allow utilities to recover, dollar for dollar, their cost of gas. Due to the fluctuation of gas costs, a tracking mechanism such as the PGA is necessary to avoid frequent rate cases. The PGA allows utilities to adjust their rates to recover gas costs without the need for frequent rate proceedings. (Commission Order, Docket No. 94-0403 dated August 23, 1995, p. 2)

While it is correct that Nicor Gas' uncollectibles expense fluctuates from year to year when compared to itself in isolation, Nicor Gas' uncollectibles expense is not volatile and fluctuating when compared to the rest of the operating expenses. Uncollectibles expense should remain in the test year so it will be considered in the aggregate with the other components of the revenue requirement for the purpose of setting rates. Uncollectibles expense should not be separated out from other test year expenses and recovered through a separate rate that changes in between rate cases without considering changes in other components of the revenue requirement formula.

Therefore, the Commission should continue to include uncollectibles expense in the Company's test year. (ICC Staff Exhibit 1.0, pp. 21-23, ll. 427-541)

The evidence further demonstrates that it is not likely that uncollectibles expense, on its own, would require frequent rate cases when rates would otherwise be just and reasonable. For a single expense item to warrant a rate case when the utility is otherwise recovering all of its other costs that expense item would have to increase substantially above the other aggregate costs. As discussed above, Figure 1 and Figure 2 show that this has not been the case with Nicor Gas' uncollectibles expense. (ICC Staff Exhibit 1.0, pp. 23-24, ll. 459-482)

Nicor Gas' rate case history also demonstrates that uncollectibles expense would not require frequent rate cases. Table 1 presents a history of Nicor Gas' uncollectibles expense for each year since Nicor Gas' last rate case. (ICC Staff Exhibit 1.0, p. 25)

Line No.	Year	Uncollectibles Expense	Change from Prior Year	Percentage Change from Prior Year
(a)	(b)	(c)	(d)	
1	1995	\$7,261	NA	NA
2	1996	\$10,991	\$3,730	51.37%
3	1997	\$15,326	\$4,335	39.44%
4	1998	\$12,617	(\$2,709)	-17.68%
5	1999	\$11,770	(\$847)	-6.71%
6	2000	\$16,578	\$4,808	40.85%
7	2001	\$23,237	\$6,659	40.17%
8	2002	\$25,716	\$2,479	10.67%
9	2003	\$29,762	\$4,046	15.73%
10	2004	\$28,770	(\$992)	-3.33%
11	2005	\$30,355	\$1,585	5.51%

It has been 9½ years since Nicor Gas' last rate case. Table 1 demonstrates that Nicor Gas has experienced significant increases in uncollectibles expense during this period, when uncollectibles expense is considered in isolation. However, these increases did not cause Nicor Gas to file a rate case. (ICC Staff Exhibit 1.0, pp. 24-25, ll. 483-495)

If the Commission Does Accept Nicor Gas' Proposal, the Allocation Factor Should Be Evaluated and Revised Periodically

If the Commission does accept the Company's proposal to recover the commodity-related portion of uncollectibles through the PGA, then the Commission should reject that part of the Company's proposal that provides that the 66.6% allocation of uncollectibles to the PGA would never be subject to change. The Company's argument that the allocation is fixed in nature is inconsistent with its argument that the commodity portion of uncollectibles should be passed through the PGA because it is volatile. (Nicor Gas Exhibit 27A.0, p. 5, ll. 111-112) If the commodity portion of uncollectibles fluctuates and is unpredictable, then it follows that the split between the commodity and non-commodity portions of uncollectibles expense should be evaluated periodically to consider the impact of that fluctuation and unpredictability. (ICC Staff Exhibit 1.0, p. 26, ll. 504-517; ICC Staff Exhibit 10.0-Revised, pp. 24-25, ll. 477-495)

The Company further argues that "... the requirement to review the factor each year would simply add potential for disagreements in the reconciliation process." (Nicor Gas Exhibit 27A.0, p. 5, ll. 111-112) If it is correct that reviewing the allocation factor will be a likely source of disagreement in future reconciliation proceedings, then that merely

reinforces the need for the Commission to review it periodically. (ICC Staff Exhibit 10.0-Revised, pp. 24-25, ll. 496-500)

If the Commission Determines that the Gas Commodity Portion of Uncollectibles Expense Should be Recovered Through the PGA, Then the Commission Should Initiate a Rulemaking to Revise Part 525 Accordingly

If the Commission does determine that the gas commodity portion of uncollectibles expense should be recovered through the PGA, then the Commission should initiate a rulemaking to revise Part 525 accordingly. Any such revision to Part 525 should, at a minimum, clarify that the gas commodity portion of uncollectibles expense is to be recovered through the PGA, specify the method by which the gas commodity portion of uncollectibles expense would be identified and recovered through the PGA, and provide consistent application of this recovery method among Illinois gas utilities. (ICC Staff Exhibit 1.0, p. 27, ll. 518-530)

N. Other

1. Original Cost Determination

Staff witness Griffin testified regarding original cost determination. 83 Ill. Adm. Code 510, The Preservation of Records of Gas Utilities, Appendix A, contains requirements for the preservation of specific records. For example, journal vouchers and journal entries which support plant accounts are to be maintained “7 years prior to date as of which original cost of plant has been unconditionally determined or approved by this Commission in” an original cost determination proceeding or a rate case. Mr. Griffin recommended that the Commission conclude and make a finding in the order for

this proceeding that the Company's 12/31/03 plant balances as reflected on Schedule B-3 of the Company's filing, are approved for purposes of an original cost determination, subject to any adjustments ordered by the Commission in this proceeding. (ICC Staff Exhibit 4.0, pp. 7-8)

III. Expenses

A. Uncontested Issues

1. Lobbying Expense

Staff witness Ebrey proposed an adjustment to disallow expenses related to lobbying activities included in the Company's Outside Professional Services (ICC Staff Exhibit 2.0, p. 10, ll. 174-176 and ICC Staff Exhibit 11.0 Revised, p. 3, ll. 40 - 42). Company witness Gorenz agreed with the basis for the adjustment but disagreed with the amount of Staff's proposed adjustment. As a result, Mr. Gorenz proposed a reduction to test-year operating expenses of \$213,000 relating to non-recoverable lobbying related costs (Nicor Gas Exhibit 26B.0, p. 85, l. 1909 – 1919). Staff accepted this revised adjustment amount (ICC Staff Exhibit 11.0 Revised, p. 3, ll. 42-46).

2. Promotional and Goodwill Activities

Staff witness Pugh proposed an adjustment to remove items from the Company's contributions because they are either of a promotional, goodwill or institutional nature. (ICC Staff Exhibit 3.0, p. 14, ll. 304-307 and ICC Staff Exhibit 12.0, p. 12.0, pp. 22-23, ll. 476-479)

Company witness Suppes stated in her rebuttal testimony that in order to narrow the issues in this rate case the Company does not oppose the adjustment. (Nicor Gas Exhibit 23.0, p. 6, ll. 116-126)

3. Matching Gift Program

Staff witness Pugh proposed an adjustment to remove the charitable contributions for the Matching Gift Program since such cost should be paid by stockholders. (ICC Staff Exhibit 3.0, p. 18, ll. 402-404 and ICC Staff Exhibit 12.0, p. 23, ll. 488-491)

Company witness Suppes stated in her rebuttal testimony that in order to narrow the issues in this rate case the Company does not oppose the adjustment. (Nicor Gas Exhibit 23.0, p. 6, ll. 116-126)

4. Injuries and Damages Expense

Staff witness Pugh proposed an adjustment to reduce the 2005 test year amount for injuries and damages as a result of a revised 2004 amount provided by the Company. (ICC Staff Exhibit 3.0, Schedule 3.08) In her rebuttal testimony, Staff witness Pugh withdrew her adjustment to Injuries and Damages Expense in the interest of narrowing the issues in this proceeding. (ICC Staff Exhibit 12.0, p. 25, ll. 524-529)

5. PGA and ECR Adjustment

In direct testimony, Staff witness Struck recommended an adjustment to remove PGA and Coal Tar Rider revenues and the associated costs for presentation purposes.

Mr. Struck explained that removing these items would provide a clearer presentation of the costs and revenues used to derive the revenue requirement the Company should recover through base rates. (ICC Staff Exhibit 1.0, pp. 9-10, ll. 180-202) The Company agreed with Mr. Struck and removed PGA and coal tar rider revenues and costs from the base rate revenue requirement presented in the Company's rebuttal testimony. (Nicor Gas Exhibit 26B.0, p. 75, ll. 1691-1698) This is a matter of presentation only and has no impact upon the Company's base rates revenue requirement.

B. Depreciation Expense

Staff witness Griffin's recommends adjustments to depreciation expense based upon his adjustments to utility plant. (Staff Exhibit 13.0, Schedule 13.03). While Mr. Griffin's adjustments to utility plant are contested, his proposed adjustments to depreciation expense related to those adjustments are not contested.

C. Storage Gas Losses

Staff witness Pugh proposed an adjustment to include the cost of storage gas losses in Account 823 (Gas Losses), an operating and maintenance cost, instead of recovering the cost through the PGA charge. (ICC Staff Exhibit 3.0, p. 8, ll. 165-168 and ICC Staff Exhibit 12.0, p. 11, ll. 217-221) The Company disagreed with Staff's adjustment because the Company has been including the 2% storage withdrawal adjustment factor in the same manner since the 1970's, which is recovery through Rider 6. (Nicor Gas Exhibit 27B.0, p. 7, ll. 149-150) Company witness Harms further stated that if the Company is ordered to make a change, the method Ms. Pugh has proposed

is the best choice of the other alternatives. (Nicor Gas Exhibit 27B.0, p. 7, ll. 151-153) The Company should not be allowed to recover gas losses through the PGA. To allow this is a violation of the 83 Ill. Adm. Code Section 525, the Commission's PGA rule, and 83 Ill. Adm. Code Section 505, the Uniform System of Accounts for Gas Utilities ("USOA").

Expenses related to the operation of a storage field, including adjustments for inventory losses due to cumulative inaccuracies of gas measurements or other causes, should be recorded in Account 823, Gas Losses, an operating and maintenance expense. 83 Ill. Adm. Code Section 505.8230, Account 823 (Gas Losses) states:

This account shall include the amounts of inventory adjustments representing the cost of gas lost or unaccounted for in underground storage operations due to cumulative inaccuracies of gas measurements or other causes. ... If, however, any adjustment is substantial, the utility may, with approval of the Commission, amortize the amount of the adjustment to this Account over future operating periods.

Company witness Gorenz, in his rebuttal testimony, Nicor Gas Exhibit 26B.0, p. 76, ll. 1714-1717, stated that irrespective of the ultimate ruling on the rate design issue relating to these expenses, Ms. Pugh's calculation is inappropriate and results in a substantial understatement of the potential adjustment. Staff maintains the position that determining the amount related to gas storage losses should be calculated only on Company-owned gas in Company-owned storage reservoirs. The ratepayers should not pay for storage losses on third-party gas. (ICC Staff Exhibit 12.0, pp. 13-14, ll. 277-285)

Company witness Gorenz, in Surrebuttal Testimony, Nicor Gas Exhibit 41.0, p. 22, ll. 470-473, described an amount of the 2% withdrawal factor that is attributable to sales customers. That amount, 61% of total aquifer storage withdrawals, is used to

calculate the estimated gas storage losses for Nicor Gas-owned gas from on-system storage for the forecast 2005 test year (demonstrated on Exhibit 1 of the Company's response to Staff data request LAP 11.03 entered into the record as Staff Exhibit 23 (Tr., p. 763)). Staff accepts this calculation as a reasonable estimated amount of storage gas losses to be charged to Account 823 instead of recovery through the PGA.

Staff recommends that the Commission approve the amount of storage gas losses as calculated on the Staff Exhibit 23. This amount increases Other Operating and Maintenance, Storage costs by \$9,971,865 and decreases taxes associated with the storage gas losses by \$3,963,318.

D. Industry Association Dues

Staff witness Pugh proposed an adjustment to remove expenses associated with certain community organizations from the Company's miscellaneous expense for dues and memberships because the nature and purpose of the organizations demonstrate that membership in the community organizations are of a promotional, goodwill or institutional nature. (ICC Staff Exhibit 3.0, pp. 15-16, ll. 345-350 and ICC Staff Exhibit 12.0, p. 17, ll. 365-371) Company witness Suppes disagreed with Staff's adjustment and argued that Nicor Gas should be permitted to recover the dues associated with its participation in community and industry organizations and that Staff's characterization of these expenses as promotional and goodwill is not supported. (Nicor Gas Exhibit 23.0, pp. 6-7, ll. 134-140)

Staff witness Pugh disagreed with Company witness Suppes' assertions. As stated in Ms. Pugh's direct testimony, participation in such groups is a promotional and

goodwill practice, which, while perhaps promoting good corporate citizenship and enabling employees to keep in contact with other members of the business community, is not necessary in providing utility service. Payments to various chambers of commerce and business and economic development organizations are more appropriately characterized as dues or promotional activities for which the Company receives membership or promotional benefits in return for payment of those dues. Consequently, the ratepayers should not be burdened with the expense of the Company taking part in these community organizations. (ICC Staff Exhibit 3.0, p. 16, ll. 351-356)

On ICC Staff Exhibit 12.0, Schedule 12.04, page 2 of 2, Staff allowed recovery of the Midwest Energy and Southern Gas Association dues on the understanding that membership in energy-related organizations is an excellent resource for energy-related information. The chambers of commerce and economic development organizations are not necessary to providing utility service and should not be included in the revenue requirement. The Commission, in its Order in a Commonwealth Edison Company rate case, Docket No. 90-0169 (Order, dated March 8, 1991, p. 20), recognized the importance of utility companies interfacing with these types of organizations, yet ruled that the shareholders, rather than the ratepayers, should bear the cost of interfacing with such organizations. Furthermore, in Staff witness Pugh's direct testimony, she included numerous cases in which the Commission has consistently affirmed its position to remove the costs of such organizations. (ICC Staff Exhibit 3.0, pp. 16-17, lines 365-374) Therefore, Staff witness Pugh proposed an adjustment to remove these expenses from the Company's test year operating expenses because they are promotional in

nature and benefit the shareholders not the ratepayers. This adjustment is reflected on ICC Exhibit 12.0, Schedule 12.04.

Staff recommends that the Commission approve its adjustment to reduce Industry Association Dues for \$93,000.

E. Social and Service Club Dues

Staff witness Pugh proposed an adjustment to remove expenses associated with the dues and memberships for certain organizations from the Company's miscellaneous general expense because participation in such groups is a promotional and goodwill practice. (ICC Staff Exhibit 3.0, p. 17, ll. 378-384 and ICC Staff Exhibit 12.0, p. 20, ll. 417-423) Company witness Suppes disagreed with Staff's adjustment and argued that Nicor Gas should be permitted to recover the dues associated with its participation in community and industry organizations and that Staff's characterization of these expenses as promotional and goodwill is not supported. (Nicor Gas Exhibit 23.0, pp. 6-7, ll. 134-140)

As stated in Staff witness Pugh's direct testimony, participation in such groups is a promotional and goodwill practice, which, while perhaps promoting good corporate citizenship and enabling employees to keep in contact with other members of the business community, is not necessary in providing utility service. Payments to various chambers of commerce and business and economic development organizations are more appropriately characterized as dues or promotional activities for which the Company receives membership or promotional benefits in return for payment of those dues. Consequently, the ratepayers should not be burdened with the expense of the

Company taking part in these community organizations. (ICC Staff Exhibit 3.0, p. 17, ll. 381-387)

In the Company's Schedule C-6, pages 9-11, the purpose and nature of the organizations clearly reveals that these organizations are to promote the interest of business in the community. The chambers of commerce and economic development organizations are not necessary to providing utility service and should not be included in the revenue requirement. The Commission, in its Order in a Commonwealth Edison Company rate case, Docket No. 90-0169 (Order, dated March 8, 1991, p. 20), recognized the importance of utility companies interfacing with these types of organizations, yet ruled that the shareholders, rather than the ratepayers, should bear the cost of interfacing with such organizations. Furthermore, in Staff witness Pugh's direct testimony, she included support in which the Commission affirmed its position to remove the costs of such organizations. (ICC Staff Exhibit 3.0, p. 18, ll. 395-397) Ms. Pugh pointed out that in Central Illinois Light Company's ("CILCO") delivery service tariffs docket, Docket Nos. 99-0119/99-0131 (Consolidated), the Commission accepted this type of adjustment from Staff over the objections of CILCO. Therefore, Staff proposed an adjustment to remove these expenses from the Company's test year operating expenses because they are promotional in nature and benefit the shareholders not the ratepayers. This adjustment is reflected on ICC Exhibit 12.0, Schedule 12.05.

Staff recommends that the Commission approve its adjustment to reduce Social and Service Club Dues for \$85,000.

F. Office Supplies Expense

AG witness Effron proposed an adjustment to Office Supplies and Expense to limit expenses charged to Account 921. Mr. Effron found an increase of 37% to Office Supplies and Expense to be unreasonable and unsupported by Nicor. He proposed that the forecasted increase in this expense reflect an allowance for inflation and real system growth together of 4% annually. (AG Exhibit 1.0, p. 27, ll. 4-11) The Company argued that the test year budget was developed from the bottom-up, requiring preparers to build their budget from the lowest level of detail. Further, the Company stated that there are significant costs that are responsible for the increase in this account. (AG Exhibit 41.0, p. 25, ll. 532-539) While Staff did not make a similar adjustment to Office Supplies and Expenses, Staff agrees that Mr. Effron's adjustment to Office Supplies and Expenses is reasonable.

G. Branding Expense

AG witness Effron proposed an adjustment to advertising expense charged to Account 913. The Company has included \$630,000 of advertising expense charged to Account 913 in test year operation and maintenance expense. The advertising expense includes \$340,000 that is described as "Branding." This is the Company's allocated share of expenditures by Nicor, Inc. for corporate communications. The purpose of these expenditures appears to be to improve the corporate image and corporate reputation of Nicor, Inc. As such, Mr. Effron determined that the expenditures are not necessary for the provision of utility service and should not be included in the Company's revenue requirement. (AG Exhibit 1.0, p. 28, ll. 2-11) The Company

claimed these expenditures represent consumer-related activities that provide clear and tangible benefits to Nicor Gas customers. (Nicor Gas Exhibit 38.0, p. 6, ll. 115-117) Staff did not make an adjustment to advertising expense but did propose an adjustment for Promotional and Goodwill Activities which the Company did not oppose. (See Section A. Uncontested Issues, 1. Promotional and Goodwill Activities) While Staff did not propose an adjustment to Advertising Expense in its testimony, Staff agrees that Mr. Efron's adjustment to Advertising Expense is reasonable.

H. Stock Option Expense

The Company included \$891,000 of stock option expense in the forecasted test year operation and maintenance expenses. AG witness Efron initially proposed to eliminate the expense for the fair value of stock options from utility cost of service in his direct testimony. Mr. Efron based his adjustment on the fact that stock options reward employees based on the increase in the price of common stock shares. This is a goal that benefits shareholders, not ratepayers. He further stated that it is unreasonable to assign the costs of the stock options to ratepayers if the benefits of increased share prices inure to shareholders. Mr. Efron asserted that stock options reward management and employees for maximizing value to shareholders, not ratepayers and recommended the expense for stock options be eliminated from the utility cost of service. (AG Exhibit 1.0, p. 23, ll. 19-22 through p. 24, ll. 1-11)

Staff witness Pugh concurred with AG witness Efron's adjustment and in her rebuttal testimony proposed an adjustment to eliminate the expense for the fair market value of stock options from utility cost of service. (ICC Staff Exhibit 12.0, p. 24, ll. 515-

518) The Company rejected Mr. Effron's and Ms. Pugh's proposed disallowance for the grounds discussed in relation to incentive compensation program costs. (Nicor Gas Exhibit 40.0, p. 7, ll. 143-155)

Staff witness Pugh disagreed with the Company's grounds for rejection, reiterating that stock options reward management and employees for maximizing value to shareholders, not ratepayers and recommends the expense for stock options be eliminated from the utility cost of service.

Staff recommends that the Commission approve the adjustment to reduce Stock Option Expense for \$891,000.

I. Incentive Compensation

Staff witness Pugh proposed an adjustment to disallow incentive compensation and associated payroll taxes related to the 2005 Bonus Plans for the following reasons:

1. The incentive compensation programs ("programs") are dependent upon financial goals of the Company which benefit shareholders and not ratepayers;
2. The goals in the programs may not be met and thus no cost would be incurred by the Company yet ratepayers would have provided funding; and,
3. The disallowance of incentive compensation is consistent with prior Commission Orders. (ICC Staff Exhibit 3.0, pp. 4-5, ll. 81-88 and ICC Staff Exhibit 12.0, p. 7, ll. 134-141)

The Company disagreed with Staff's adjustment, stating that Staff's proposal is not valid, it is arbitrary and it is not in the interests of customers. (Nicor Gas Exhibit 25.0, p. 1, ll. 13-15)

The Company's arguments should be rejected. The information provided by the Company demonstrates that the programs are based on the financial goals of the Company. As stated in Staff witness Pugh's direct testimony, these types of goals are based upon circular reasoning; that is, the larger the rate increase granted, the more success Nicor will have in achieving its earnings goals. Thus, Nicor will further enhance its ability to award incentive compensation to the extent that incentive compensation is included in the Nicor's new rates. These goals primarily benefit shareholders; therefore, shareholders should bear the cost. (ICC Staff Exhibit 3.0, p. 5, ll. 93-102)

Furthermore, the Company has failed to support its position by providing the detailed evidence of objectives measured by tangible or quantifiable results and the specific dollar savings or tangible benefits conferred upon ratepayers from its incentive compensation plan. The Company did not cite any specific instances of hiring problems within its labor market. Furthermore, the Company did not provide clear evidence showing that incentive compensation payments are necessary to pay the labor market average and to retain employees. (ICC Staff Exhibit 12.0, p. 9, ll. 174-180)

The Commission has applied a consistent set of principles that have disallowed recovery of incentive compensation expense in cases where the plan ties incentive compensation to criteria designed to ensure shareholder benefits but not ratepayer benefits. In Docket No. 93-0183, the Commission concluded that, since financial goals benefit shareholders, ratepayers should not have to bear the cost:

Two of the goals, earnings per share and reduced O & M expenses are goals that benefit shareholders. If the shareholders are the ones to benefit, they should be the ones who foot the bill.⁸

In addition, the Commission is not convinced that the ratepayers are protected in the event that the targeted return on capital investment is not achieved. In Docket No. 99-0534, the Commission reached a similar conclusion regarding ratepayer benefit from incentive compensation based on financial goals:

The Commission is not convinced that the ratepayers are protected in the event that the targeted return on capital investment is not achieved. Ratepayers would still fund the projected levels of incentive compensation even if that level is not achieved.⁹

AG witness Effron proposed an adjustment to reduce payroll expense. Included in Mr. Effron's adjustment to pro forma test year payroll expense is the elimination of incentive compensation. Mr. Effron stated that it is his understanding that the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations. (AG Exhibit 1.0, p. 21, ll. 11-23) Further, Mr. Effron stated that the Company has not demonstrated that its incentive compensation program will reduce expenses and create greater efficiencies in operations, thereby producing net benefits to ratepayers. (AG Exhibit 1.0, p. 22, ll. 6-16) In his rebuttal testimony, Mr. Effron continued to exclude incentive compensation and updates his adjustment using the actual 2004 payroll expense. (AG Exhibit 1.3, p. 20, ll. 6-13) AG witness Effron's adjustment is different from Staff's from the aspect that he only includes the 2005

⁸ Illinois Power Company, ICC Docket No. 93-0183, p. 52 (Order entered April 6, 1994).

⁹ MidAmerican Energy Company, ICC Docket No. 99-0534, p.9 (Order entered July 11, 2000).

forecasted amount expensed as Staff's adjustment includes total costs for the incentive plans, amounts expensed plus amounts capitalized.

Staff recommends that the Commission exclude from test year operating expense a total of \$6,555,000 (\$6,089,000 for incentive compensation expense and \$466,000 for associated payroll tax expense) related with the bonus plans dependent upon financial goals of the Company which benefit shareholders and not ratepayers. This adjustment is reflected on ICC Exhibit 12.0, Schedule 12.02.

J. Payroll Expense

AG witness Effron made two adjustments to payroll expense: (1) adjustment to payroll expense, based on the actual 2004 employee level; (2) removal of incentive compensation expenses, based on the Commission's general practice.

Nicor assumed that the employee count would increase by 50 in 2005. However, Mr. Effron noted that the number of employees in recent years has not shown any noticeable upward trend, and the Company did not demonstrate that the assumed increase of 50 employees in the 2005 test year was reasonable. Therefore, he did not reflect the assumed increase in determining the 2005 payroll expense. Mr. Effron's adjustment to payroll expense also excludes incentive compensation. (AG Pretrial Memorandum, pp. 8-9) Staff addressed the incentive compensation issue in Section III. EXPENSE, I. Incentive Compensation section of this document. While Staff did not make a similar adjustment relating to the increase of 50 employees in the 2005 payroll expense, Staff agrees that Mr. Effron's adjustment to remove costs with the assumed increase of 50 employees is reasonable.

K. Payroll Tax

AG witness Effron proposed an adjustment to Payroll Taxes which is a result of his adjustment to Payroll Expense. Staff proposed an adjustment to Incentive Compensation which results in a corresponding adjustment to Payroll Taxes. If the Commission determines adjustments are warranted to Payroll Expense and Incentive Compensation, then the corresponding adjustments to Payroll Taxes are reasonable.

L. Corporate Benefit Plan Expense

AG witness Effron proposed an adjustment to Corporate Benefit Plans to reduce test year expenses by the increase to administrative and general salaries due to the Company's assumption that the payout would increase to 100% in 2004 and stay there in 2005. (AG Exhibit 1.0, p. 24, ll. 16-21) Mr. Effron stated that the Company has not provided any reason to believe that the forecasted payout ratio of 100% is any more likely than the actual payout ratio of 50% experienced in 2003. (AG Exhibit 1.0, 25, ll. 3-5) The Company argued that it is just another attempt to make a selective update of Nicor's test year forecast which Nicor has shown to be on track. (Nicor Pretrial Memorandum, p. 33) While Staff did not make an adjustment to Corporate Benefit Plans, Staff agrees that Mr. Effron's adjustment to Corporate Benefit Plans is reasonable.

M. Interest Expense on Customer Deposits

AG witness Effron's adjustment to Customer Deposits had the collateral effect of increasing the Interest on Customer Deposits (AG Exhibit 1.0, Schedule B-4). By its opposition of Mr. Effron's adjustment to Customer Deposits, it also opposes this "fall-out" adjustment to interest expense. If the Commission determines that Mr. Effron's adjustment to Customer Deposits is appropriate, so also must the associated interest expense be adjusted.

N. Interest Synchronization

Staff witness Struck proposed an interest synchronization adjustment based upon Staff's proposed rate base and Staff's proposed weighted cost of debt. (ICC Staff Exhibit 1.0, p. 5, ll. 88-97, Schedule 1.06; ICC Staff Exhibit 10.0-Revised, pp. 4-5, ll. 76-90, Schedule 10.06-Revised) The Company took issue with Mr. Struck's adjustment because the Company takes issue with the underlying contested rate base adjustments and weighted cost of debt that are reflected in Mr. Struck's adjustment. (Nicor Gas Exhibit 26B.0, p.88, ll. 1974-1988; Nicor Gas Exhibit 41.0, p. 28, ll. 614-620) However, Staff and the Company do agree about the methodology to be used for the interest synchronization adjustment and that the final interest synchronization adjustment in this case should be based upon the rate base and weighted cost of debt approved by the Commission in this case. (Tr., p. 358, l. 6 through p. 360, l. 6)

O. Uncollectibles Expense

In its rebuttal testimony, the Company proposed to revise its test year uncollectibles expense from that presented in its direct testimony to reflect higher Rider

6 revenues and a higher loss ratio. (Nicor Gas Exhibit 26B.0, pp. 79-81, ll. 1761-1831) AG witness Effron did not disagree with the Company's proposal in principal, but Mr. Effron did disagree with the Company's use of a 1.40% loss ratio rather than a 1.30% loss ratio. (AG Exhibit 1.3, pp. 16-17) Mr. Effron presented an analysis of the Company's loss ratio for the years 1999 through 2004, which he believes supports the use of a 1.30% loss ratio. (AG Exhibit 1.3, Schedule C-2a) The Company disagreed with Mr. Effron's analysis alleging that Mr. Effron incorrectly compares net charge-offs to current revenues rather than the revenues that gave rise to such charge-offs. (Nicor Gas Exhibit 41.0, p. 22, ll. 474-487) The Company contends that the correct analysis is to compare net charge-offs to the revenues eight months earlier. (Nicor Gas Exhibit 26B.0, pp. 79-81, ll. 1780-1815) (Nicor Gas Exhibit 41.0, p. 23, ll. 501- 505) The Company indicates that in the first quarter of 2005, it began recording uncollectibles expense at 1.40% of revenues and has increased this to 1.45% of revenues for the second quarter of 2005. (Nicor Gas Exhibit 41.0, p. 24, ll. 515- 518) Staff reflected the Company's revised uncollectibles amounts in its schedules. (ICC Staff Exhibit 10.0-Revised, Schedules 10.07and 10.08-Revised)

P. Income Tax Expense

Staff witness Struck reflected the respective income tax impact of each operating income statement adjustment proposed by Staff, in his revenue requirement schedules. (ICC Staff Exhibit 1.0, Schedules 1.01 and 1.02, ll. 19-20; ICC Staff Exhibit 10.0-Revised, Schedules 1.01-Revised and 1.02-Revised, ll. 19-20) AG witness Effron also proposed an adjustment to incorporate the collective income tax effect of his proposed

adjustments. (AG Exhibit 1.0, p. 29, Schedule C-5) The Commission should also reflect the income tax impact of those adjustments it accepts in this proceeding.

Q. Rate Case Expense

The Company proposed to amortize rate case expense over a five-year period which it believes is “conservative and reasonable” based on the determination made in its last general rate case and the amortization periods approved in recent rate cases (Nicor Gas Exhibit 26B.0, p. 84, ll. 1886 – 1888).

Staff witness Ebrey proposed a \$268,000 decrease to Rate Case Expense based on Staff’s use of an eight year amortization period (ICC Staff Exhibit 11.0 Revised, p. 4, ll. 74 – 76). Staff witness Ebrey’s eight year amortization period was based upon an analysis of the Company filed rate cases in 1981, 1987, 1995 and the instant case in 2004. Her analysis showed that the length of time between the rate cases has been six, eight, and nine years, or an average of approximately eight years over this 23-year period. Based on the Company’s rate case filing history, Staff’s eight-year amortization period is the time the rates can be expected to be in effect. Also of significance is that an analysis of Nicor’s historical rate case filings shows an identifiable definite trend of increasingly longer periods of time between each successive rate case. Company witness Hawley confirms that Nicor Gas has a history of having rate cases very infrequently and that Nicor remains committed to attempting to limit the number of rate increases it seeks over time (Nicor Gas Exhibit 18A.0, p. 22, ll. 456-457, 461 – 462). Given the Company’s rate case filing trend and its commitment to continue to limit its

requests for rate increases, Staff in fact could have proposed an amortization period of ten or eleven years rather than the eight year period.

When comparing the Company's five year period to Staff's eight year period for rate case amortization, the Commission should consider the impact of choosing too short an amortization period. The Commission need only look back to the Company's most recent rate case. In that proceeding, the Commission approved a five-year amortization period which resulted in an annual rate case expense of \$220,000 (ICC Staff Exhibit 11.0 Revised, Attachment A). Since those rates will soon have been in effect for 9 years, the Company has over-recovered 4 years of rate case expense or \$880,000. Therefore, the five-year period approved was not conservative as the Company suggests. Given the Company's history in filing rate cases, it would be conservative and reasonable to amortize rate case expense over an eight-year period.

At the other end of the spectrum is the possibility of the Commission choosing too long an amortization period. However, in the instance of an under-recovery of rate case expense, the Commission has allowed a utility to include Commission-approved unamortized rate case expense in its calculation of rate case expense in the subsequent rate case. (United Cities Gas Docket No. 00-0228, MidAmerican Energy Company Docket No. 01-0696, AmerenCIPS/UE Docket Nos. 02-0798/03-0008/03-0009 Cons.). Therefore, based upon prior Commission Orders, if Nicor were to file a rate case prior to the end of the eight-year amortization period recommended by Staff, Nicor could be allowed to include an unamortized balance of rate case expense from the current proceeding in that rate case. However, no mechanism exists for instances of over-recovery such as have occurred since the final order in Docket No. 95-0219. As

a result, ratepayers do not have an opportunity to recapture any excess rate case expense paid as a result of choosing too short an amortization period.

The Company infers that Staff is being inconsistent in its proposal of an eight-year amortization period since the amortization periods for rate case expense in recent history have not been higher than 5 years (Nicor Gas Exhibit 26B.0, p. 84, ll. 1893 – 1895). The Company fails to recognize that the *length* of the amortization period is not how one determines whether there has been consistency. Rather, it is the underlying *basis* for the amortization period that should be evaluated. That evaluation shows that Staff is indeed consistent with prior Commission decisions in its basis for the proposed amortization period. Using the examples cited by the Company, Staff demonstrates this to be true. (ICC Staff Exhibit 11.0 Revised, pp. 4-9, ll. 72-168)

Nicor's five year amortization period is based strictly on Nicor's knee jerk adoption of the amortization period approved in the last Nicor rate case, which resulted in an \$880,000 over-recovery of rate case expense that cannot be refunded to the ratepayers. Most of the rate case examples to which Nicor cites only further support the methodology that Staff used in developing the appropriate eight year amortization period for rate case expense. The remaining cases cited by the Company contained no analysis with respect to the reasoning for choosing a particular amortization period. Therefore, it is the Company that has shown minimal regard for prior Commission orders; Staff's proposed adjustment decreasing rate case expense by \$268,000 should be approved.

R. Gross Revenue Conversion Factor

Staff's Gross Revenue Conversion Factor ("GRCF") differs from the one the Company used in its direct testimony. The Company used a state income tax rate of 7.5%. The state income tax rate should be 7.3%. AG witness Effron makes the same proposal as Staff. (AG Exhibit 1.0, p. 4) In its rebuttal testimony, the Company concurred with this change. (Nicor Gas Exhibit 26B.0, p. 89, ll. 2005-2011)

S. Other

IV. Weather Normalization

Introduction and Statement of Facts

Illinois' gas and electric utility rates are based on various factors, including, but not limited to, expected customer usage. (ICC Staff Exhibit 9.0, p. 5, ll. 111-112) A forecast for customer usage is based in part on expected weather: other things being equal, a forecast based on colder weather and higher therm sales will produce lower per therm rates than a forecast based on warmer weather and lower therm sales. (ICC Staff Exhibit 9.0, pp. 5-6, ll. 111-115) Normal weather used to set rates for Illinois' gas and electric utilities has been based on an average of 30 years of heating degree day and cooling degree day data. (ICC Staff Exhibit 9.0, p. 2, ll. 36-38) Heating degree days are a measure of cold weather. Specifically, heating degree days are the difference between the average of a day's high and low temperatures and 65 degrees. (ICC Staff Exhibit 9.0, p. 4, ll. 71-77) If the day's high and low temperatures are 50 degrees and 30 degrees, respectively, the average is 40 degrees. Subtracting the average from 65

degrees produces 25 heating degree days. Illinois' gas utilities have based their rates on 30 years of heating degree day data. Illinois' electric utilities have based their rates on 30 years of cooling degree day data.

Nicor Gas, in this case, proposes to change the Commission's long-standing policy of using 30 years of heating degree data to establish normal weather for purposes of determining the rates charged customers. Staff's position is that Nicor Gas' proposal sets the stage for Illinois' gas and electric utilities to devise weather normalization periods that best suit their purposes. (ICC Staff Exhibit 18.0, pp. 2-3, ll. 45-47)

Staff's Position

Staff witness Beyer recommends that the Commission obtain input from other gas and electric companies on the issue of weather normalization and be well-informed of the broader effects of a decision to abandon the practice of using a 30-year period to establish weather normalized test year billing determinants. (ICC Staff Exhibit 18.0, p. 2, ll. 31-36) If the Commission accepts the premise of Nicor Gas' proposal, which is that northern Illinois, the midwest, the United States, and the planet are experiencing a warming trend not just in the winter, but annually, then one can conclude that an electric company sharing Nicor Gas' service territory will also be affected by warmer weather. (ICC Staff Exhibit 18.0, p. 5, ll. 99-112) Specifically, Mr. Beyer notes that Nicor Gas' proposal to recognize the effects of warmer weather in northern Illinois will have the opposite effect on the development of rates for ComEd: if the Commission accepts Nicor Gas' position and argument that a weather normalization adjustment should be based upon data for the most recent 10-year period to reflect a recent climatic change

toward warmer weather and follows that decision in the next rate case for an electric utility (e.g., ComEd), the result will be to drive downward the rate per kilowatt hour for that electric company's new rates. (ICC Staff Exhibit 18.0, p. 4, ll. 71-77)

Mr. Beyer noted that the Company's proposal to abandon the 30-year normal weather period is based partly on fact (historical degree days, for example), and partly on judgment (the Company's choice of 10-year data instead of some other period such as 8 or 12 years). (ICC Staff Exhibit 9.0, p. 3, ll. 66-69; ICC Staff Exhibit 18.0, p. 3, ll. 51-57) Company witness Professor Takle testified, in reference to the Easterling et al. report, that a period of time between 6 and 20 years is recommended. (Nicor Gas Exhibit 16.0, pp. 25-26, ll. 552-563) Mr. Beyer further noted that the Company provided no evidence that the proposed period of 10 years is superior to some other period within that range, such as 8 or 12 years. (ICC Staff Exhibit 18.0, p. 3, ll. 54-57) The absence of a Company response on this point provides support for Mr. Beyer's contention that, if allowed, utilities will seek and support weather normalization periods that best suit their purposes (i.e., to maximize revenues).

Mr. Beyer proposes that the Commission can explore the issue of how to best determine normal weather in a proceeding that would allow Illinois' gas and electric utilities to articulate their positions on the issue. By using that approach, the Commission could gather comprehensive evidence on differences and similarities of weather impacts upon utilities' service territories. During cross-examination by Chief Judge Aridas, Mr. Beyer explained that ICC Staff would begin the process by distributing a letter to Illinois' gas and electric utilities and to interested parties seeking their responses to a set of questions on the weather issue. Upon receipt of parties'

responses to Staff's questions, Staff would study the responses, follow up as needed, consider meetings or a workshop, and plan next steps. (Tr., p. 853, lines 1-22, and p. 854, ll. 1-9)

Mr. Beyer also recommended that, regardless of the period chosen by the Commission for determining normal weather in this case, the Company should be required to file a weather adjustment tariff subsequent to the final order in this case that would mitigate the revenue effects of variations between actual and normal weather. (ICC Staff Exhibit 18.0, pp. 15-17, ll. 337-342, and ll. 369-382) A weather adjustment tariff would provide assurance to the Company that it can recover its costs, and it would also provide assurance to the customers that they are reimbursing the Company for no more and no less than its prudently incurred costs.

In summary, Staff's position recognizes that determining the best approach to normal weather is a complex task based on objective and subjective elements. The Commission has used one standard for many years and has applied that standard to determine normal weather for all natural gas and electric utilities whose customers' usage is affected by weather. The proposal made by Nicor Gas presents a universal issue that is neither unique to Nicor Gas nor limited to natural gas utilities. It is Staff's position that the Commission can deviate from its long-standing practice, but should only do so after having considered the positions and recommendations of all natural gas and electric utilities and other parties that want to comment on all utilities' proposals. (ICC Staff Exhibit 9.0, p. 7, ll. 142-152)

V. Rate of Return

Introduction and Statement of Facts

Five witnesses submitted testimony regarding the Company's cost of capital. On behalf of Nicor Gas, Dr. Jeff D. Makholm presented testimony regarding the Company's cost of equity (Nicor Gas Exhibits 4.0-4.18, 21.0-21.11, and 37.0-37.1) and Messrs. Richard L. Hawley and Robert R. Mudra presented testimony regarding the Company's proposed capital structure and overall weighted average cost of capital ("WACC"). (Nicor Gas Exhibits 3A.0 and 20A.0 and Nicor Gas Exhibits 3B.0-3B.4, 20B.0-20B.8, and 36.0-36.2, respectively) On behalf of Staff, Mr. Michael McNally presented testimony regarding the Company's cost of equity, capital structure, and WACC. (ICC Staff Exhibits 5.0-5.13 and 14.0-14.5) On behalf of CUB and the CCSAO, Mr. Christopher C. Thomas presented testimony regarding the Company's cost of equity, capital structure, and WACC. (CUB-CCSAO Exhibits 1.0-1.14 and 3.0-3.14)

The parties agree that the embedded cost of Nicor Gas' long-term debt is 6.72%. (Nicor Gas Exhibit 36.1; ICC Staff Exhibit 14.0, Schedule 14.1; CUB-CCSAO Exhibit 3.0, p. 2) The parties also agree that the embedded cost of Nicor Gas' preferred stock is 4.77%. (Nicor Gas Exhibit 36.1; ICC Staff Exhibit 14.0, Schedule 14.1; CUB-CCSAO Exhibit 3.0, p. 2)

The parties do not agree with respect to the inclusion of short-term debt in the capital structure, adjustments to the capital structure component balances, the cost of short-term debt, and the cost of common equity.

Nicor Gas proposes the following capital structure and cost of capital (Nicor Gas Exhibit 36.1, p. 2):

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	\$500,376,000	43.51%	6.72%	2.92%
Preferred Stock	\$1,401,000	0.12%	4.77%	0.01%
Common Equity	\$648,156,000	56.37%	10.82%	6.10%
Total Capital	\$1,149,943,000	100.00%		
Weighted Average Cost of Capital				9.03%

Staff proposes the following capital structure and cost of capital (ICC Staff Exhibit 14.0, Schedule 14.1):

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	\$177,608,285	13.65%	2.58%	0.35%
Long-term Debt	\$478,311,049	36.77%	6.72%	2.47%
Preferred Stock	\$1,386,101	0.11%	4.77%	0.01%
Common Equity	\$643,607,150	49.47%	9.54%	4.72%
Total Capital	\$1,300,912,585	100.00%		
Weighted Average Cost of Capital				7.55%

CUB/CCSAO proposes the following capital structure and cost of capital (CUB-CCSAO Exhibit 3.0, p. 35):

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	\$177,608,000	13.38%	2.58%	0.35%
Long-term Debt	\$500,376,000	37.69%	6.72%	2.53%
Preferred Stock	\$1,401,000	0.11%	4.77%	0.01%
Common Equity	\$648,156,000	48.82%	9.86%	4.81%
Total Capital	\$1,327,541,000	100.00%		
Weighted Average Cost of Capital				7.697%

A. Capital Structure (Inclusion of Short-Term Debt)

1. Nicor Gas' position

The Company's proposed capital structure, as presented above, is based on a forecasted December 31, 2005 measurement date. (Nicor Gas Exhibit 36.1, p. 2) Although the Company forecasts that it will have short-term debt outstanding for nine

months during 2005 capital structure measurement period (Nicor Gas Exhibit 20B.0, p. 18), Mr. Mudra did not include that short-term debt in his capital structure recommendation. He contended that short-term debt is not a permanent source of financing for the Company's rate base investments. (Nicor Gas Exhibit 3B.0, pp. 5-6) Rather, he argued that Nicor Gas uses short-term debt as a seasonal cash management tool while rate-base is long-term in nature. (Nicor Gas Exhibit 20B.0, p. 18) Mr. Mudra assumed that short-term debt funds non-rate base cash requirements and that other sources of funds finance the variable components of Nicor Gas' rate base. (Nicor Gas Exhibit 20B.0, pp. 18, 27-28)

Mr. Mudra maintained that if the Commission concludes that Nicor Gas' short-term debt should be included in its capital structure, the balance should only be \$36,625,000. (Nicor Gas Exhibit 20B.0, p. 17; Nicor Gas Exhibit 36.0, p. 3) That amount was derived by subtracting the balances for customer deposits, budget plan balances, and customer advances for construction from the gas in storage balance. That calculation assumes that gas in storage is the only rate base item financed with short-term debt, and that it is financed with short-term debt only to the extent that its balance exceeds the total of customer deposits, budget plan balances, and customer advances for construction.

2. Staff's position

Staff witness McNally originally proposed a capital structure based on an average 2005 measurement period. (ICC Staff Exhibit 5.0, p. 3) However, in the interest of reducing the number of contested issues, and because it made very little difference to the cost of capital, Mr. McNally adopted a December 31, 2005

measurement date for all of the long-term components of the capital structure and an average 2005 balance for short-term debt. (ICC Staff Exhibit 14.0, pp. 8-9) Mr. McNally's recommendation includes the Company's net short-term debt balance, which was calculated by removing from the Company's gross short-term debt balance the portion of short-term debt already reflected in the allowance for funds used during construction ("AFUDC").

Mr. McNally stated that, due to the fungibility of capital, one cannot identify which capital source funds which assets. Since Nicor Gas consistently relies on short-term debt as a source of funds, short-term debt should be included in Nicor Gas' capital structure unless it is shown that short-term debt does not support rate base, as described in Commission rule 83 Ill. Adm. Code 285.4010(a). Nicor Gas, which carries the burden of proof in this regard, failed to make that showing.

3. CUB/CCSAO's position

CUB/CCSAO witness Thomas adopted Staff's recommended balance of short-term debt, rounded to the nearest \$1,000, and Nicor Gas' recommended balances for long-term debt, preferred stock, and common equity. (CUB/CCSAO Exhibit 3.0, p. 35)

4. Arguments

Mr. Mudra stated that his proposed capital structure, which contains only long-term capital, represents Nicor Gas' "actual" capital structure and implied that including short-term debt results in a hypothetical capital structure. (Nicor Gas Exhibit 3B.0, p. 5; Nicor Gas Exhibit 20B, pp. 13, 23, 29, and 36) Mr. Mudra's statement is both misleading and unhelpful. His statement is misleading since the Company forecasted that it will use short-term debt during nine of the twelve months of 2005 and has a long

history of relying on short-term debt to finance its operations. (Staff Exhibit 5.0, Schedule 5.2; Nicor Gas Exhibit 20B.0, p. 22) Thus, short-term debt is an important source of capital for the Company. Further, 83 Ill. Adm. Code 285.4010(a) indicates that short-term debt is a part of a utility's capital structure unless short-term debt can be shown to financing exclusively assets excluded from rate base. His statement is unhelpful since it is devoid of substance (i.e., it does not address the Company's use of short-term debt); hence, it does not assist the Commission to decide this or any other issue.

The overriding error in Mr. Mudra's argument that short-term debt should be excluded from Nicor Gas' capital structure stems from the mistaken implication that Nicor Gas' rate base balance is constant over time. Mr. Mudra stated that "the assets in Nicor Gas' rate base are long-term assets that are, and must be, funded with capital compensated at long-term rates." (Emphasis added, Nicor Gas Exhibit 20B.0, pp. 16-18) Thus, he argued that Nicor Gas' seasonal use of short-term debt is inconsistent with it being a source of funding for Nicor Gas' "long-term" rate base. (Nicor Gas Exhibit 20B.0, p. 18) That argument, his repeated false labeling of the assets in Nicor Gas' rate base as "long-term," and his continual emphasis on the variable nature of short-term debt imply that Nicor Gas' rate base balance is constant. However, Nicor Gas' rate base is not exclusively composed of long-term assets and its balance indisputably varies. For example, working gas, which is included in Nicor Gas' rate base, is not categorized as a long-term asset, but rather, as a current (i.e., short-term) asset. (ICC Staff Exhibit 14.0, p. 6) In addition, the Company employs 13-month averages for the balances of rate base components "materials and supplies" and "gas in storage"

specifically because of the relatively high degree of variability of their balances. Indeed, the monthly gas in storage balance alone will vary by over \$331 million throughout the test year. (Nicor Gas Exhibit 26.1, Schedule 1.01, p. 2) In contrast, balances of Nicor's long-term capital sources (i.e., long-term debt, preferred stock, and common equity) vary so little over the test year that Nicor Gas deemed that a single measurement date, December 31, 2005, was sufficient to measure them accurately. (Nicor Gas Exhibit 36.1) Given the static nature of the balances of Nicor Gas' long-term capital sources, the highly variable gas in storage balance must have a similarly variable source of funding. Short-term debt is that variable source. (ICC Staff Exhibit 14.0, pp. 6-7)

Mr. Mudra implied that short-term debt does not match the long-term return requirements of "rate base investors." (Nicor Gas Exhibit 20B.0, p. 29) That implication is erroneous. The Company has no "rate base investors,"¹⁰ as investors purchase a company's securities, not its assets. Rather, Nicor Gas has short-term debt investors, long-term debt investors, preferred stock investors, and one common stock investor, Nicor, Inc. Clearly, investors in Nicor Gas' short-term debt do not seek long-term returns on that investment. Thus, a short-term return matches the return requirements of Nicor Gas' short-term investors. Even if one were to suspend disbelief and accept the proposition that a "rate base investor" exists, the statement that short-term debt does not match the alleged long-term return requirements of those "rate base investors" would be true only if one begins with the conclusion that short-term debt does not support rate base. Such circular reasoning defies logic.

¹⁰ If utilities had "rate base investors" then rate base would be a component of utility capital structures; however, 83 IL Adm. Code 285 Subpart G does not recognize rate base as a capital structure component.

Mr. Mudra argued that, because Nicor Gas forecasts zero short-term debt balances for three months during the test year, short-term debt must not be financing rate base. (Nicor Gas Exhibit 20B.0, p. 18) Mr. Mudra is wrong. Some of Nicor Gas' rate base components display indisputable, significant variation. Thus, "permanency," in the sense of continual, positive balances, is not a prerequisite for including short-term debt in the capital structure. The Commission made that abundantly clear in Docket No. 95-0076 by including short-term debt in Illinois American Water Company's ("IAWC") capital structure despite the fact that IAWC projected zero short-term debt balances for three months of the test year, just as Nicor Gas has in the instant docket. (Order, Docket No. 95-0076, December 20, 1995, pp. 49 and 51)

Mr. Mudra also claimed that short-term debt finances non-rate base cash requirements and that other sources of funds finance the variable portion of Nicor Gas' rate base. (Nicor Gas Exhibit 20B.0, pp. 18, 27-28) Mr. Mudra failed to supply any valid support for those claims. He simply assumed that other sources of funds finance rate base, which he arbitrarily designated as the first use of funds, while assuming that short-term debt finances non-rate base assets, which he arbitrarily designated as the last use of funds. That is, Mr. Mudra attempted to trace capital, which is impossible, due to the fungibility of capital.

Mr. Mudra misleadingly claimed that Staff's recommendation to include short-term debt in Nicor Gas' capital structure is inconsistent with past Commission decisions. (Nicor Gas Exhibit 20B.0, pp. 20-22) He noted that short-term debt was excluded from Nicor Gas' capital structure in its previous rate cases, Docket Nos. 87-0032 and 95-0219, and argued that the Commission should likewise exclude short-term debt from

Nicor Gas' capital structure in the instant docket, since the Company currently uses short-term debt in the same manner as it did at the time of the prior proceeding. (Nicor Gas Exhibit 36.0, p. 2) However, the Commission policy of short-term debt changed over the intervening nine years. Since that time, the Commission revised its rules to state that "Short-term debt shall be included in the capital structure unless the utility demonstrates that short-term debt is entirely financing assets, such as CWIP or seasonal working capital, that are not included in the utility's rate base." (83 Ill. Adm. Code Part 285 4010(a) (effective August 1, 2003)) The revised rule clearly places the presumption that short-term debt shall be included in a utility's capital structure. In contrast, Docket Nos. 87-0032 and 95-0219 were decided under the former standard, in which short-term debt was presumed not to be supporting rate base unless shown otherwise.¹¹

Finally, Mr. Mudra argued that the inclusion of short-term debt in Nicor Gas' capital structure would represent unsound policy and would produce a capital structure

¹¹ Of the two previous Nicor Gas rate case, Docket Nos. 87-0032 and 95-0219, the former states the old short-term debt standard more clearly:

The Commission is further of the opinion that short-term debt should not be included in Respondent's capital structure for the purpose of setting rates herein. The cost of short-term debt is volatile and should only be included in capital structure when it is clear that it is a permanent component of a utility's rate base. (Order, Docket No. 87-0032, January 20, 1988, p. 26)

In contrast, the Commission Order in Docket No. 95-0219 states only:

The Commission finds that the capital structure as recommended by the Staff, and concurred in by the Company, is reasonable and appropriate. We do not find Mr. Selecky's argument regarding short-term debt to be convincing or consistent with prior Commission decisions and we, therefore, reject his argument on that issue. (Order, Docket No. 95-0219, April 3, 1996, p. 38)

that is unjust and unreasonable. (Nicor Gas Exhibit 20B.0, p. 2) Mr. Mudra falsely characterized the inclusion of cost of short-term debt in a company's capital structure as a "penalty" for the use of short-term debt and implied that Staff proposes the inclusion of short-term debt "simply to lower returns." (Nicor Gas Exhibit 36.0, p. 5) This position is clearly incorrect. With regard to the former, MidAmerican Energy Company ("MEC") made the same argument in Docket No. 99-0534, and the Commission rejected it. The Order states the Company's position and the Commission's finding as:

According to MidAmerican, Staff's apparent requirement that the utility not use any short-term debt unless it wishes to be penalized by the inclusion of same in its capital structure would result in poor financial management, poor ratemaking and poor public policy.

The Commission does not find compelling MidAmerican's contention that it will be penalized by including short-term debt in its capital structure for purposes of setting rates. Contrary to MidAmerican's assertion, the Commission does not oppose the use of short-term debt to permanently finance non-CWIP expenditures, as long as the overall capital structure is reasonable. (Order, Docket No. 99-0534, July 11, 2000, pp. 10-11.)

With regard to the latter, Staff proposes including short-term debt in the capital structure in order to accurately measure the cost of capital to apply to rate base. Mr. Mudra's argument that the inclusion of short-term debt would understate the investor-required return assumes the conclusion that short-term debt does not support rate base. (Nicor Gas Exhibit 20B.0, pp. 23-24) As Staff has shown, the Company has not met its burden on that issue. Furthermore, if the Company truly felt it would not be in its best interest to continue to use short-term debt, its forecasts, presumably, would not reflect a continued use of short-term debt, since such use of short-term debt is entirely at the Company's discretion. However, given that the Company continues to utilize short-term debt, its rates should include the cost of that capital.

5. Summary

The Commission has concluded that short-term debt shall be included in the capital structure unless the utility demonstrates that short-term debt is entirely financing assets that are not included in the utility's rate base. (83 Ill. Adm. Code 285-4010(a)) The Company has not made such a showing. Since Nicor Gas includes assets with balances that vary greatly throughout the test year in its rate base, there must be a variable source of capital to support those assets. Nicor Gas does have a variable source of capital in short-term debt, which very closely tracks the variability in the Company's single most variable rate base asset, gas in storage. Even Standard and Poor's ("S&P") concluded that Nicor Gas uses short-term debt to purchase gas in storage. (ICC Staff Cross Exhibit 19.0 (Nicor Response to MGM 7.01)) In summary, if short-term debt were excluded from the Company's capital structure, Nicor Gas' customers would compensate the Company for a higher rate of return on capital than the Company is paying to its investors. This would unjustly enrich Nicor Gas' investors at the expense of its customers. Therefore, as a matter of regulatory fairness, the Commission should include short-term debt in the capital structure for the purpose of establishing rates.

B. Adjustments to Capital Structure Component Balances

1. Nicor Gas' position

Company witness Mudra argues that if short-term debt is excluded from the Company's capital structure, an adjustment to reflect the Commission's formula for

calculating AFUDC is unnecessary. However, Mr. Mudra notes that if short-term debt is to be included, Staff's adjustment for CWIP balances accruing AFUDC should be incorporated into Nicor Gas's capital structure. (Nicor Gas Exhibit 36.0, pp. 3 and 21)

2. Staff's position

Staff witness McNally measured the short-term debt in Nicor Gas' capital structure by calculating the average 2005 net short-term debt balance. (ICC Staff Exhibit 5.0, p. 6) Nicor Gas' net short-term debt balance was used to avoid the double-counting concern arising from the Commission's formula for calculating AFUDC, which assumes that short-term debt is the first source of funding CWIP. The Commission's formula for calculating AFUDC also assumes that any remaining CWIP not funded by short-term debt is funded by the Company's other sources of capital (i.e., long-term debt, preferred stock, and common equity) proportionally. Thus, Mr. McNally removed the remaining CWIP accruing AFUDC not attributed to short-term debt proportionally from the balances of long-term debt, preferred stock, and common equity. (ICC Staff Exhibit 5.0, p. 6)

3. CUB/CCSAO's position

Although CUB/CCSAO witness Thomas adopted Staff's short-term debt balance recommendation, which includes an adjustment to reflect the Commission's formula for calculating AFUDC, he made no corresponding adjustment to his long-term capital balance recommendations. Mr. Thomas adopted the long-term capital structure component balances recommended by the Company in its rebuttal testimony, which did not reflect such an adjustment. (CUB-CCSAO Exhibit 3.0, p. 35)

4. Summary

The Commission should adopt Staff's proposed balances of short-term debt, long-term debt, preferred stock, and common equity. They are consistent with the Commission's rule regarding the formula for calculating the AFUDC, since Staff's proposed balances avoid double counting amounts assumed to be supporting construction-work-in-progress. (Staff Exhibit 5.0 Corrected, p. 7)

C. Cost of Short-Term Debt

1. Nicor Gas' position

The Company proposes a 4.12% cost of short-term debt. (Nicor Gas Exhibit 36.2) The Company's estimate reflects a forecasted interest rate plus commitment fees.

2. Staff's position

Staff estimates the Company's cost of short-term debt is 2.58%. (ICC Staff Exhibit 5.0, pp. 12-13) Staff's estimate is based on the February 7, 2005 interest rate on AA-rated commercial paper and does not reflect commitment fees. The Company has failed to establish the reasonableness of the commitment fees reflected in its short-term debt cost recommendation and, thus, should not be allowed to recover them through rates. (ICC Staff Exhibit 14.0, p. 7)

3. CUB/CCSAO's position

CUB-CCSAO adopted Staff's cost of short-term debt recommendation. (CUB-CCSAO Exhibit 3.0, p. 8)

4. Arguments

The cost of short-term debt should reflect the cost of commitment fees related to the Company's short-term debt, if those commitment fees are shown to be reasonably incurred. However, until its surrebuttal testimony, the Company did not even explicitly state the purpose for the bank commitments, let alone demonstrate that the bank commitment fees are reasonably incurred. The Company claimed that its surrebuttal testimony addressed the concerns Staff raised, but its response was incomplete.¹² Mr. Mudra revised the cost of Nicor Gas' bank commitments in his rebuttal testimony to \$1.6 million, but did not indicate (1) the amount of the new bank commitments; (2) the amount of those bank commitments that are assigned to Nicor Inc.; and (3) whether the \$1.6 million bank commitment expense reflects a proper 3-year amortization of those costs over the 3-year life of the bank agreement. (Nicor Gas Exhibit 20B.4; Tr., p. 239) Since the bank commitments are shared between Nicor Inc. and Nicor Gas (Staff Cross Exhibit 22.0), a proper allocation of the bank commitment fees must be made to satisfy the requirements of 220 ILCS 5/9-230. Pursuant to that section of the PUA, not one iota of incremental cost of capital resulting from a utility's affiliation with non-utility

¹² Mr. Mudra's claim that an A-1+/P-1 commercial paper rating is dependent on the sufficiency of bank credit facilities used as backup does not address how large such bank credit facilities need to be. (Nicor Gas Exhibit 36.0, pp. 18-19) Further, Mr. Mudra's lack of familiarity with an S&P report setting forth its rating process for commercial paper indicates he is not sufficiently informed on the subject to render an expert opinion. (Tr., p. 231; Staff Cross Exhibit 20)

companies can be reflected in rates. Thus, given the current incomplete state of the record on bank commitment fees, the Commission cannot legally add a single basis point to Nicor Gas' cost of capital for those fees. (Illinois Bell Company v. Illinois Commerce Commission, 283 Ill.App.3d 188, 207 (1996))

D. Cost of Equity

1. Nicor Gas witness Malkolm's Analysis

Dr. Makholm used two methodologies to estimate the cost of common equity for Nicor Gas: discounted cash flow ("DCF") and Capital Asset Pricing Model ("CAPM") analyses. (Nicor Gas Exhibit 4.0, p. 8) In those analyses, Dr. Makholm employed a sample of six dividend-paying publicly-traded companies that derive at least 80% of their operating revenues from regulated utility operations. (Nicor Gas Exhibit 4.0, pp. 19-22) Dr. Makholm performed his initial analysis using data available as of September 17, 2004. (Nicor Gas Exhibit 4.0, pp. 24-29) He subsequently updated his analysis using data available as of February 7, 2005. (Nicor Gas Exhibit 21.0, p. 5)

a. DCF Analysis

The DCF model requires the analyst to estimate three basic inputs: the growth rate, the prospective dividend, and the stock price. The basic DCF model is stated as follows:

$$K = D_1/P_0 + g$$

Where	K	=	the required rate of return
	D_1	=	the prospective dividend
	P_0	=	the current stock price
	g	=	the prospective growth rate

Dr. Makholm averaged growth rates estimates from three sources: Zacks Investment Research (“Zacks”) and two growth rate estimates he developed from data published by Value Line. The first of those two self-developed growth rates, his “sustainable growth” methodology, is intended to measure growth from new investment in each company in his sample. The second set of growth rate estimates Dr. Makholm developed, which he referred to as the “Value Line” growth rates, reflects the growth rate implied by the difference between the 2003 EPS reported in Value Line and Value Line’s forecast of EPS for the 2007-2009 period. For purposes of his calculation, Dr. Makholm treated the EPS forecast for the 2007-2009 period as a 2008 EPS forecast. Thus, he calculated the implied geometric average annual growth of EPS over a five-year period (2003-2008). (Nicor Gas Exhibit 4.0, pp. 27-30)

To develop prospective dividend estimates (i.e., D_1) for each of the companies in his samples, as required by the DCF model, Dr. Makholm multiplied the sum of the past four quarterly dividend payments (i.e., D_0) by his growth rate estimate. (Nicor Gas Exhibit 4.0, p. 27)

Dr. Makholm adjusted stock price data from *Yahoo! Finance* to remove the accrued value of the next quarterly dividend payment from the stock price. (Nicor Gas Exhibit 4.0, pp. 24-26) Dr. Makholm then applied a second adjustment to each stock price by multiplying the dividend-adjusted stock price by a 97.46% discount factor to compensate investors for estimated common stock issuance and selling costs. This

discount allegedly reflects the concept that, due to issuance costs, the cash paid in by investors might exceed the net proceeds available for investment in company assets; although investors demand the required return on their gross investment amount, the authorized return is based on the net amount invested in rate base. (Nicor Gas Exhibit 4.0, pp. 30-34; Nicor Gas Exhibit 21.8) Dr. Makholm's final DCF estimate of the cost of common equity for his sample was 10.68%. (Nicor Gas Exhibit No. 21.0, p. 5)

b. CAPM Analysis

Although Dr. Makholm is generally critical of use of the CAPM in utility rate cases, he developed a CAPM estimate as a check of the reasonableness of his DCF estimate. (Nicor Gas Exhibit 4.0, pp. 8 and 36-39) The CAPM is stated as follows:

$$K = R_f + \beta \times (R_m - R_f)$$

Where	K	=	the required rate of return
	R _f	=	the risk-free rate
	β	=	Beta
	R _m	=	the expected return on the market

Dr. Makholm estimated the risk-free rate with the 4.68% yield on 30-year Treasury bonds. Dr. Makholm relied exclusively on the adjusted Value Line beta for each company in his gas sample to estimate his sample beta of 0.80. (Nicor Gas Exhibit No. 21.0, p. 5)

Dr. Makholm estimated the expected return on the market using a top-down DCF analysis of the required return on the S&P 500. (Nicor Gas Exhibit 4.0, p. 38; Nicor Gas Exhibit 21.0, p. 21) Dr. Makholm's S&P 500 DCF estimate was calculated by multiplying the 1.72% dividend yield by one plus the 10.57% average *Yahoo! Finance* five-year growth rate for the S&P 500 companies, and adding the resultant to the

10.57% growth rate. This produced a preliminary estimate of the required return on the S&P 500 of 12.47%. Dr. Makhholm then added a 0.05% allowance for issuance expenses, producing a final DCF estimate of the market return of 12.52%. (Nicor Gas Exhibits 21.10 and 21.11)

Inputting the 4.68% yield on 30-year Treasury bonds, a sample beta estimate of 0.80, and a rate of return on the market of 12.52% into the CAPM formula above produced a cost of common equity estimate for Dr. Makhholm's sample of 10.95%. (Nicor Gas Exhibit 21.0, p. 5)

c. Request

The Company requests a cost of equity for Nicor Gas of 10.82%, which equals the average of Dr. Makhholm's 10.68% DCF estimate and 10.95% CAPM estimate, even though Dr. Makhholm did not recommend use of the CAPM for determining the cost of common equity. (Nicor Gas Exhibit 4.0, pp. 16, 35-37; Nicor Gas Exhibit 21.0, pp. 1, 18-19)

2. Staff Witness McNally's Analysis

Staff Witness Michael McNally estimated the cost of common equity for Nicor Gas with DCF and risk premium models. DCF and risk premium models cannot be applied directly to Nicor Gas because its common stock is not market-traded. Therefore, Mr. McNally applied those models to a sample of natural gas utility companies ("Gas Sample"). The Gas Sample comprises eight cash dividend paying, domestic, publicly-traded companies assigned an industry number of 4924 (i.e., natural gas distribution companies) within S&P's *Utility Compustat* database for which Zacks growth forecasts were available; that were not involved in any large, pending merger;

and that derive 70% or more of their revenues from regulated gas delivery operations based on 2003 data. (ICC Staff Exhibit 5.0, p. 14)

a. DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in Mr. McNally's Gas Sample pay dividends quarterly. Therefore, Mr. McNally applied a constant-growth quarterly DCF model. (ICC Staff Exhibit 5.0, pp. 15-16)

DCF methodology requires a growth rate that reflects the expectations of investors. Mr. McNally measured the market-consensus expected growth rates with projections published by Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of February 7, 2005. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimates of the cost of common equity was 9.14% for the Gas Sample. (ICC Staff Exhibits 5.0, pp. 16-19)

b. Risk Premium Analysis

According to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with the theory that investors are risk-averse. That is, investors require higher returns to accept greater exposure to risk. In equilibrium, two securities with equal quantities of risk have equal required rates of return. Mr. McNally used a one-factor risk premium model, the CAPM, to estimate the

cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. (ICC Staff Exhibit 5.0, pp. 19-20)

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Mr. McNally combined betas from Value Line and a regression analysis. The average Value Line beta estimate was 0.76, while the regression beta estimate was 0.56. (ICC Staff Exhibit 4.0, pp. 25-27) For the risk-free rate parameter, Mr. McNally considered the 2.28% yield on four-week U.S. Treasury bills and the 4.54% yield on twenty-year U.S. Treasury bonds. Both estimates were measured as of February 7, 2005. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 5.6% and 6.0%. Thus, Mr. McNally concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. (ICC Staff Exhibit 5.0, pp. 20-25) Finally, for the expected rate of return on the market parameter, Mr. McNally conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 13.40%. (ICC Staff Exhibit 5.0, p. 25) Inputting those three parameters into the CAPM, Mr. McNally calculated a cost of common equity estimate of 10.39% for the Gas Sample. (ICC Staff Exhibit 4.0, p. 28)

c. Recommendation

Based on his DCF and risk premium models, Mr. McNally estimated that the cost of common equity for the Gas Sample is 9.77%. To determine the suitability of that cost of equity estimate for Nicor Gas, Mr. McNally compared the average S&P corporate credit ratings and business profiles of his Gas Sample to those of Nicor Gas to assess their relative risk levels. The S&P credit rating and S&P business profile score for the

Gas Sample average approximately A and 2.75, respectively. In comparison, S&P assigns Nicor Gas a corporate credit rating of AA and a business profile score of 2. The Gas Sample's lower average corporate credit rating and higher average business profile score indicate that the Gas Sample is significantly riskier than Nicor Gas in terms of overall financial strength. Thus, Mr. McNally concluded that a downward adjustment to the Gas Sample's investor-required rate of return is necessary to estimate the investor-required rate of return for Nicor Gas. Mr. McNally adjusted the Gas Sample's investor-required rate of return downward by 23 basis points, which reflects the spread between A-rated and AA-rated 30-year utility debt yields. Mr. McNally concluded that such an adjustment is reasonable, since the average credit rating of the Gas Sample is A and Nicor Gas' credit rating is AA. (ICC Staff Exhibits 5.0, pp. 29-30)

Mr. McNally testified that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. A cost of common equity recommendation based solely upon judgment is inappropriate. However, because cost of common equity measurement techniques necessarily employ proxies for investor expectations, judgment is necessary to evaluate the results of such analyses. Thus, Mr. McNally analyzed the distribution of the individual DCF estimates relative to the observable 5.31% yield on A-rated long-term utility bonds. Mr. McNally concluded that the required rate of return on common equity for Nicor Gas equals 9.54%. Mr. McNally did not include an adjustment for common equity flotation costs since the Company failed to prove that it had any unrecovered common equity flotation costs. (ICC Staff Exhibit 5.0, p. 28-31)

3. Critical Errors in Dr. Makhholm's Analysis

Mr. McNally found several errors in Dr. Makhholm's analysis that cast doubt on its accuracy and reliability. Critical errors occur in, or are the result of, the growth rates Dr. Makhholm applied in his DCF model, his failure to adjust his cost of equity estimate to reflect the lower risk of Nicor Gas relative to his proxy sample, and his improper application of a flotation cost adjustment.

a. Growth Rates

Both the "BR" and the "SV" components of Dr. Makhholm's sustainable growth rate estimates are flawed. The BR component is intended to measure the expected growth from reinvested earnings by multiplying the earnings retention ratio, B, by the expected return on the earnings retained, R. Dr. Makhholm mismatched the higher return on *average* equity, R_{AV} , with the higher *end-of-year* book value, V_e , which produces an overstated earnings estimate.¹³ (ICC Staff Exhibit 14.0, pp. 28-29)

In addition, Dr. Makhholm's sustainable growth rate estimate is not only internally inconsistent, but is inconsistent with its application in Dr. Makhholm's DCF model. The retention ratio Dr. Makhholm calculated for the BR component of his sustainable growth rate is a forecasted 2007-2009 retention ratio, but the dividend yield component of his DCF model incorporates dividend expectations for 2003-2007 as well as 2007-2009 and beyond. Dr. Makhholm acknowledged that the 2007-2009 Value Line forecasts reflect a decreasing payout ratio. All else equal, a decreasing payout ratio produces lower

¹³ For consistency, Dr. Makhholm should have either multiplied return on end-of-year equity with end-of-year book value or return on average equity with average book value.

dividend growth in the near term than the growth Dr. Makholm assumed. Thus, Dr. Makholm combined in his DCF model the higher 2003 dividend yield, reflecting the higher near-term payout ratio, with a higher growth rate that reflects the lower 2007-2009 payout ratio. (ICC Staff Exhibit 5.0, p. 35 and Schedule 5.13)

The SV component of Dr. Makholm's sustainable growth rate estimates, which is intended to measure the expected growth from new common stock issuances, is also biased upward, due to his incorrect assumption that all new common stock will be issued at the prevailing market price, which Dr. Makholm estimated equals 1.9x book value. However, Dr. Makholm did not know whether all new common stock *was*, let alone *will be*, issued at a 90% premium to book value. In contrast, Mr. McNally explained that due to the use of stock options for officer and employee compensation, which are issued at prices below the prevailing market price, the 1.9x average book value to market value ratio assumed for Dr. Makholm's sample and the resulting sustainable growth rate estimates are upwardly biased. Moreover, Mr. McNally presented documents that show that at least some of the common stock issuances of the companies in Dr. Makholm's sample were, in fact, exercised stock options. Since some of the new common stock is very likely to be issued at less than a 90% premium over book value, the SV component of the sustainable growth rate estimates is overstated. (ICC Staff Exhibit 5.0, pp. 36-37; ICC Staff Exhibit 14.0, p. 30)

Dr. Makholm's "Value Line" growth rate estimate, which equals the geometric average annual growth in a company's EPS from 2003 to Value Line's forecasted EPS for 2007-2009, is also seriously flawed. Dr. Makholm made no attempt to normalize the base-year 2003 EPS data in his "Value Line" growth rate estimates, despite

acknowledging the importance of normalizing those same earnings to calculate his sustainable growth rate estimates. Because EPS can fluctuate substantially from year to year, the EPS in any single year may be either above or below “normal.” Thus, the implied growth rate can change significantly depending on the base-year selected. In this case, the record shows that the average return on equity for Dr. Makholm’s sample is lower in the 2003 base year than the 2007-2009 forecast period.¹⁴ (Tr., pp. 275-277; Nicor Gas Exhibit 21.5) As a result, his Value Line growth rate reflects an unsustainable acceleration of growth. In summary, the average growth rate for the entire sample, upon which Dr. Makholm’s cost of equity estimate relies, is inflated due to failure to normalize his base-year EPS data.¹⁵ (ICC Staff Exhibit 5.0, pp. 36-37 and Schedule 5.13)

In opting to calculate his own “Value Line” growth rate estimates using Value Line EPS forecasts, Dr. Makholm disregarded the EPS growth rate estimates explicitly published by Value Line, which are imbedded in the Value Line EPS forecasts. Significantly, Value Line acknowledges that nonrecurring events or cyclical swings in any one year can distort the growth picture of a company and, thus, normalizes its base-year earnings rather than relying upon the EPS for any single base year, as Dr. Makholm did. The average of Value Line’s published EPS growth estimates for the

¹⁴ Earnings per share is a function of return on equity. (Tr., pp. 274-275)

¹⁵ The unsustainable acceleration reflected in the “Value Line” growth rates is evident in the large divergence of the sample average “Value Line” growth rate (8.10%) from the sample average Zacks (4.74%) and upwardly biased “BR+SV” (5.15%) growth rates. This divergence is mostly due to the “Value Line” growth rates for Cascade Natural Gas (12.24%) and Southwest Gas (13.73%), which are more than double the second highest growth rate estimate for those companies (i.e., 6% for Cascade Natural Gas and 6.76% for Southwest Gas). (Nicor Gas Exhibit 21.7)

companies in Dr. Makholm's sample, exclusive of Nicor, Inc., is more than two full percentage points below the average of Dr. Makholm's calculated "Value Line" growth rates for the same five companies. (ICC Staff Exhibit 5.0, pp. 37-38) Dr. Makholm curiously argued that the approach he used to develop his "Value Line" growth rate estimate is preferable to the five-year EPS growth rates Value Line publishes, because Value Line's normalization technique is flawed. Although Staff agrees that Value Line's normalization technique is flawed, obviously Dr. Makholm's decision not to normalize earnings at all is not a valid solution and has led to excessive growth rates. (ICC Staff Exhibit 14.0, p. 32)

b. Risk Adjustment

Nicor Gas has been assigned a credit rating of AA and a business profile score of 2 by S&P. S&P states, "[a]n obligor rated AA has a VERY STRONG capacity to meet its financial commitments. It differs from the highest rated obligors only in small degree." (ICC Staff Exhibit 5.0, p. 38) In addition, an S&P business profile score of 2, on a scale of 1 to 10, reflects a low level of business risk. In contrast to Nicor Gas, Dr. Makholm's proxy sample has an average credit rating of A and business profile score of 2.5, which indicate that Dr. Makholm's sample is significantly riskier than Nicor Gas. Thus, a downward adjustment to the results of Dr. Makholm's sample is necessary. Dr. Makholm's failure to make such an adjustment caused him to overestimate the required rate of return on common equity for Nicor Gas. (ICC Staff Exhibit 5.0, pp. 38-39)

To assess the risk of his sample, Dr. Makholm relied solely on his sample selection criterion, percentage of revenue from distribution operations in 2003, which he claimed satisfies his first basic objective: to assemble a group of companies with

publicly-traded stock that are representative, on average, of the business risk faced by Nicor Gas' natural gas distribution operations. (Nicor Gas Exhibit 4.0, p. 20) However, a company's overall risk is composed of both business risk and financial risk. Nicor Gas' AA rating and his sample's A average rating, indicate that Dr. Makholm's sample has a significantly higher degree of financial risk than Nicor Gas. That difference in financial risk is evident in the 60.6% average ratio of total debt to total capital for Dr. Makholm's sample, as compared to 50.27% for Nicor Gas. The cost of equity adopted for setting Nicor Gas' rates should reflect the total risk of Nicor Gas, not just its business risk. (ICC Staff Exhibit 5.0, p. 39) The record incontrovertibly demonstrates that the total risk of Dr. Makholm's sample is significantly higher than that of Nicor Gas. Thus, without a downward adjustment, the cost of equity estimate for his proxy sample overstates the cost of equity for Nicor Gas.

c. Inconsistencies

The Company's cost of equity analysis contains several inconsistencies. First, despite using Yahoo! Finance growth rates in his CAPM analysis and arguing that "a credible analysis should use all of the credible sources available," Dr. Makholm excluded from his final growth rate estimate the Yahoo! Finance growth rate estimates for the companies in his sample. Second, he extolled the virtues of Value Line and criticized Staff for not employing Value Line as a source for growth rates, while simultaneously criticizing Value Line's normalization technique and disregarding the growth rates Value Line publishes in favor of his own, contrived growth rates. Third, he improperly combined the higher return on *average* equity, R_{AV} , with the higher *end-of-year* book value, V_e , to calculate his sustainable growth rate estimates, which he

inconsistently input into a DCF model that incorporates dividend expectations for an yet a different time period. Fourth, although Dr. Makholm concluded that Zacks is a reputable firm and uses Zacks growth rates, he dismissed Zacks published beta estimates. Fifth, although Dr. Makholm criticized the use of the CAPM in utility rate setting, the Company included the results of Dr. Makholm's CAPM in its final cost of equity recommendation. Finally, although Nicor Gas is one of the most financially sound gas distribution utilities in the nation, the Company's cost of equity recommendation actually exceeds the average allowed cost of equity for a miscellaneous group of utilities presented by Dr. Makholm that, on average, is undoubtedly higher in risk. Paradoxically, the inconsistencies above are consistent in one respect: in each case, the Company chose to disregard evidence that would have yielded a lower estimate of the cost of common equity.

4. Response to the Company's Criticisms

The Company had several criticisms regarding inputs used in Staff's cost of common equity recommendation, including Staff's Gas Sample, growth rate, CAPM, and relative risk adjustment. The Company claims that Staff's cost of equity recommendation is too low, as compared to returns allowed other gas utilities in 2004 and 2005. Those complaints are without merit, as explained below.

a. Gas Sample

Dr. Makholm raised two objections Mr. McNally's Gas Sample. First, he noted that, based on year-end 2004 data that was unavailable at the time of Staff's analysis, four of the companies in the Gas Sample would no longer meet the sample selection criteria originally adopted and concludes that those four companies should be excluded

from Staff's analysis. Second, he suggested that the Gas Sample should include KeySpan Corporation and Southwest Gas, both of which are categorized as natural gas distribution companies by Value Line. (ICC Staff Exhibit 14.0, p. 15)

Mr. McNally explained that, ideally, there would be an abundance of 100% gas distribution companies from which to build a sample for Nicor Gas. Unfortunately, there is not. The 70% threshold Mr. McNally initially adopted was selected to balance measurement error due to sample composition against measurement error due to individual company cost of equity estimates (i.e., the sample's similarity to the target, in terms of its operations, versus the sample size). Mr. McNally concluded that, using 2003 data, adopting a 70% threshold produced a sample that is sufficiently large to minimize measurement error and yet remains composed of companies whose operations are largely gas distribution. (ICC Staff Exhibit 14.0, p. 16)

Dr. Makholm noted that, for 2004, the percent of revenue from regulated natural gas distribution operations for AGL Resources, Laclede Group, Peoples Energy, and South Jersey Industries fell below Staff's selected threshold of 70% of revenue from natural gas utility operations. (Nicor Gas Exhibit 21.0, pp. 6-7) However, the fact that those four companies fell below Staff's selected 70% threshold during 2004 does not necessarily indicate that they are poor proxies for Nicor Gas.

The purpose of using a criterion based on percentage of revenue from gas distribution operations is to produce a sample of companies whose predominant line of business is gas distribution. Thus, Mr. McNally examined the companies in his sample a second time. Mr. McNally testified that he found that each of the four companies Dr. Makholm recommended be eliminated from Staff's Gas Sample remains, fundamentally,

a gas distribution business and remains appropriate for inclusion in the Gas Sample for the following reasons: (1) Each of those four companies still derives a substantial majority (at least 61%) of its revenue from gas distribution operations. In contrast, the Commission previously accepted the results of a sample that included a company with revenues from gas distribution operations of as low as 42%; (2) Each of those four companies declares gas distribution to be its core operation, is included in Value Line's natural gas distribution industry group, and has a Standard Industrial Classification code of 4924, which comprises establishments engaged in the distribution of natural gas for sale; (3) AGL Resources, Peoples Energy, and South Jersey Industries derived 74%, 82%, and 77% of their respective operating incomes from gas distribution operations, while Laclede Group derived 89% of its net income from gas distribution operations; and (4) Gas distribution assets represent 78%, 91%, 82%, and 81% of the consolidated assets of AGL Resources, Laclede Group, Peoples Energy, and South Jersey Industries, respectively. (ICC Staff Exhibit 14.0, pp. 17-18)

Further, revenue is an imperfect proxy for measuring operating risk. Mr. McNally explained that gas distribution revenues can be greatly impacted by variable factors, including weather and natural gas prices. Thus, based on revenues alone, the same company could appear to be appreciably different in terms of operating risk from one year to the next, even though its overall operating risk had not changed. Moreover, although the percentage of revenue sample selection criterion is designed to produce a proxy sample that is reasonably similar to Nicor Gas in terms of *operating* risk, it does not ensure the sample closely matches Nicor Gas's *overall* risk level, since revenues do not capture financial risk at all. (ICC Staff Exhibit 14.0, pp. 17-18)

Dr. Makhholm argued that substituting KeySpan and Southwest Gas for AGL Resources, Laclede Group, Peoples Energy, and South Jersey Industries would create a sample that better reflects the risk of Nicor Gas. (Nicor Gas Exhibit 21.0, pp. 6-8) If so, the new sample should be lower in risk than Staff's Gas Sample, given that Nicor Gas is lower in risk than the Gas Sample, as indicated by their respective credit ratings of AA and A and business position scores of 2 and 2.75. Thus, the new sample should have a lower cost of equity, since investors require a lower return on a lower-risk investment. However, Dr. Makhholm found that the DCF cost of equity estimate resulting from that substitution would be higher than that for the original Gas Sample.¹⁶ Thus, either the new sample is riskier than the Gas Sample, and thus less similar to Nicor Gas, or the average DCF estimate reflects a higher degree of measurement error. Either explanation indicates that Staff's Gas Sample better balances between the two types of measurement error than the six-company sample resulting from Dr. Makhholm's proposed substitution would. (ICC Staff Exhibit 14.0, p. 21)

Finally, the results of Staff's analysis would be very similar if Keyspan and Southwest Gas were added to the Gas Sample without removing any other companies. Adding those two companies to Staff's sample would create a 10-company sample with an average credit rating and average business profile score of A/A- and 2.9, respectively, as compared to the A and 2.75 for Staff's original Gas Sample. This indicates that the 10-company sample is slightly more risky, and, thus, less similar to Nicor Gas, than the original 8-company Gas Sample. The DCF and CAPM results

¹⁶ Of course, if the DCF estimate were lower for the revised gas sample, Dr. Makhholm would likely not have argued for that revision.

corroborate this. The DCF and CAPM estimates for the 10-company sample would be 9.07% and 10.56%, respectively, producing a final estimate for the 10-company sample of 9.82%, as compared to 9.77% for Staff's eight-company Gas Sample. Of course, since the credit rating and business profile score indicate a larger difference between the 10-company sample and Nicor Gas, a larger risk adjustment would be necessary for the 10-company sample estimate than was applied to the eight-company sample estimate. The spread between average of the 30-year yields for A and A- rated utilities and the yield for 30-year AA rated utilities is approximately 32 basis points. This would produce a final cost of equity for Nicor Gas of 9.50%, which is very similar to Staff's original 9.54% estimate. (ICC Staff Exhibit 14.0, p. 22)

b. Growth Rate

Dr. Makholm criticized Mr. McNally's analysis for omitting growth rates based on Value Line data. (Nicor Gas Exhibit 21.0, pp. 11-13) Dr. Makholm's criticism is both disingenuous and baseless. With regard to the latter, Zacks investment services averages growth rate estimates from multiple sources to derive its growth rate estimates. Further, as previously explained, Dr. Makholm's Value Line-based growth rate estimates are severely flawed. (ICC Staff Exhibit 14.0, p. 27)

With regard to the former, although Dr. Makholm argued that growth rates derived from Value Line data should be included in any cost of equity analysis because Value Line is perhaps the most popular and credible source of all, he declined to use the growth rates published by Value Line in his analysis and criticized Value Line's normalization methods. Thus, Dr. Makholm criticized Staff's analysis for not using a source that he criticized. In addition, although he stated that "a credible analysis should

use all of the credible sources available,” Dr. Makhholm excluded from his final growth rate estimate the Yahoo! Finance growth rate estimates he included among his workpapers despite finding Yahoo! Finance to be a sufficiently credible source for growth rates for calculating the required return on the overall market used in his CAPM. Not surprisingly, the average of the Yahoo! Finance growth rates for Dr. Makhholm’s sample is lower than the average for any of the growth rates he employed. (ICC Staff Exhibit 14.0, pp. 27-28)

c. CAPM

Dr. Makhholm argued that it is preferable to use published betas that are visible to investors. (Nicor Gas Exhibit 37.0, p. 10) However, the validity of a beta estimation methodology is not a function of whether the resulting beta estimates are readily visible to the market. Rather, the validity of the methodology is a function of whether it is generally accepted. The methodology Staff used to calculate the Gas Sample beta, which the Commission has accepted in numerous proceedings, is based on the widely-accepted Merrill Lynch methodology.¹⁷ Further, Dr. Makhholm distanced himself from his argument when confronted with the fact that Zacks, which Dr. Makhholm had described as a reputable firm, publishes beta estimates for the Gas Sample based on the Merrill Lynch methodology that average 0.44, which is lower than the 0.56 beta Mr. McNally estimated through the regression methodology. When combined with the Value Line beta, the resulting Gas Sample beta would be 0.60 and the CAPM estimate of the Gas

¹⁷ Except for the substitution of the NYSE Composite Index for the S&P500 Index as a proxy for the market return. Using the NYSE Composite Index as a proxy for the market return produced higher betas than using the S&P500 Index.

Sample's cost of common equity would be 9.86% rather than the 10.39% estimate calculated with the regression beta.. (ICC Staff Exhibit 14.0, pp. 34-35)

d. Relative Risk Adjustment

Dr. Makholm argued that because of Staff's Gas Sample's lack of comparability to Nicor Gas, Staff's 23 basis point adjustment to reflect the risk differential between the Gas Sample and Nicor Gas is unsound. (Nicor Gas Exhibit 21.0, p. 1) His argument is illogical. Dr. Makholm's assertion that the Gas Sample is not representative of Nicor Gas does not support the conclusion that a 23 basis point adjustment is unsound. Rather, his assertion, if correct, would support the need for just such an adjustment. Indeed, the less representative the Gas Sample is of Nicor Gas, the greater the need for an adjustment. (ICC Staff Exhibit 14.0, p. 23)

Dr. Makholm also leveled the patently false charge that Mr. McNally's 23 basis point equity risk adjustment to the results of the Gas Sample was "pulled...out of the air" and contended that average credit rating differences "have no conceptual read-across to any possible equity risk difference" and that Staff's adjustment "has no credible basis from a standpoint of financial theory or practice." (Nicor Gas Exhibit 21.0, pp. 9-10) Dr. Makholm is wrong again. The risk/return tradeoff (i.e., investors require higher returns to accept greater exposure to risk) is a fundamental principle of finance. That concept forms the basis of Staff's adjustment. While Dr. Makholm is correct that credit ratings do not directly measure common equity risk, to therefore conclude that there is no relationship between credit risk and equity risk is incorrect. Nobel prize winners Modigliani & Miller conclude that equity costs are affected by debt leverage. S&P credit ratings are also affected by debt leverage. That is, as debt leverage rises, the cost of

equity rises and credit ratings fall and vice versa. Thus, there is an inverse relationship between credit ratings and equity costs. While there is no way to directly measure that relationship, to ignore the significant risk differential indicated by Staff's Gas Sample's A rating and Nicor Gas' AA rating, as Dr. Makhholm espoused, would clearly be inappropriate. Therefore, Mr. McNally used the observable the 23 basis point difference between the cost of AA-rated and A-rated 30-year utility debt as a proxy for the difference between Nicor Gas' and the Gas Sample's costs of equity. Mr. McNally's approach in this proceeding is consistent with the approach the Commission has taken under similar circumstances in previous proceedings. (ICC Staff Exhibit 14.0, pp. 23-25; Order, Docket No. 98-0632, March 24, 1999, pp. 4-5; Order Docket Nos. 02-0798/03-0008/03-0009 (Cons.), October 22, 2003, pp. 80 and 89-90)

Furthermore, as Dr. Makhholm acknowledged that, due to the contractual payment obligation of bonds, bondholders have a high degree of certainty that they will be repaid in a timely manner, whereas equity holders are entitled only to residual cash flows after bond payments are met. (Nicor Gas Exhibit 21.0, p. 10) Thus, the risk to a company's equity holders is clearly affected by the risk of default on its debt securities, as reflected in its credit rating. Indeed, as CUB-CCSAO witness Thomas notes, the higher risk of non-payment to equity holders suggests that Staff's adjustment is, if anything, understated. (CUB-CCSAO Exhibit 3.0, p. 14)

e. Assessment of Cost of Equity Estimate

Dr. Makhholm claimed that Mr. McNally's estimate is too low in comparison to other allowed returns and may have a negative effect on Nicor Gas' financial integrity. (Nicor Gas Exhibit 21.0, pp. 2, 23-25, and 29; Nicor Gas Exhibit 37.0, pp. 2-3) Once

again, Dr. Makhholm is wrong. First, Dr. Makhholm did not identify the risk level, as exemplified by credit rating or any other risk metric, of any of the utilities involved in those return decisions. Nor did he identify the capital structure that was adopted or the amount of the common stock flotation cost adjustment, if any, that was included in each of those decisions. Without such data, any evaluation of the return recommendations in this proceeding via comparison to the returns authorized in the cases Dr. Makhholm cited is useless, since the Commission has no basis on which to assess comparability. (ICC Staff Exhibit 14.0, p. 37) Indeed, given that every gas distribution utility in the U.S. has a lower S&P credit rating than Nicor Gas' AA rating, one would expect Nicor Gas' required return on equity to be considerably lower than average. Moreover, for the 64 returns Dr. Makhholm presented, the average return for the first 32 (from January 2002 through July 2003) is 50 basis points higher than the average return for the last 32 (from August 2003 through April 2005).¹⁸ All else equal, those results suggest that equity return requirements for utilities are falling. Thus, it is quite consistent for Staff's cost of equity recommendation to be below the costs of equity authorized for other gas utility companies over the past 3½ years. In contrast, the Company's requested cost of equity is actually higher than the average return authorized in the cases Dr. Makhholm cited. (Nicor Gas Exhibit 21.0, p. 24; Nicor Gas Exhibit 37.0, pp. 2-3)

Second, Staff's cost of capital analysis was designed to produce the overall return required on capital for Nicor Gas, given its current AA rating and business profile score of 2. The total debt ratio of 50.27%, upon which Staff based its cost of capital

¹⁸ In addition, of those 64 returns, the eight returns authorized by the Wisconsin public utility commission are the eight highest, which indicates that the Wisconsin decisions are outliers and, thus, questionable benchmarks against which to compare cost of equity recommendations.

recommendation, is consistent with an AA rating for a utility with a business profile score of 2, based on S&P benchmarks. Also, the pre-tax interest coverage ratio of 3.82x implied by Staff's capital structure and component cost estimates is quite generous for an AA rating and a business profile score of 2, based on benchmarks S&P previously employed. Thus, Staff's recommendations reflect a reasonable level of financial risk and should allow Nicor Gas to maintain its strong financial condition. (ICC Staff Exhibit 14.0, p. 38)

Finally, S&P corroborates Staff's position. Notwithstanding a decline in the Company's financial profile during 2004, S&P concludes that Nicor Gas ratios still remain within the range acceptable for the 'AA' rating category. S&P notes weaknesses or threats Nicor faces as its "investment in higher-risk unregulated operations and uncertainties regarding investigations into alleged abuses of Nicor Gas' performance-based rate plan (PBR), a shareholder derivative action, and a possible civil injunction action, all of which could result in financial penalties." Thus, Nicor Gas' current financial profile is sufficient for current ratings, and the only abnormal risks S&P identifies should not be reflected in rates. (ICC Staff Cross Exhibit 19.0)

E. Flotation Costs

Staff has two concerns with Dr. Makhholm's recommended flotation cost adjustment. First, Nicor Gas has failed to demonstrate that it has incurred but not recovered the fees upon which its flotation cost adjustment is based. The Commission Order from Commonwealth Edison Company, Docket No. 94-0065, states that "The

Commission has traditionally approved [flotation cost] adjustments only when the utility anticipates it will issue stock in the test year or when it has been demonstrated that costs incurred prior to the test year have not been recovered previously through rates.” Moreover, that Order states that “[the utility] has the burden of proof on this issue.” Thus, flotation costs are to be allowed only if a utility can verify both that it has incurred the specific amount of flotation costs for which it seeks compensation and that those costs have not been previously recovered through rates. The Company has not done either. (ICC Staff Exhibit 5.0, p. 40)

The Company argued that the Commission has not previously allowed recovery of flotation costs. (ICC Staff Exhibit 21.0) However, the Company did not cite from a single Commission Order, let alone provide any documentation to support this claim. Moreover, the Commission has stated that the lack of a reference to recovery of such costs in previous orders is not sufficient evidence to support an adjustment for flotation costs. (ICC Staff Exhibit 5.0, p. 41)

The only actual documentation the Company provided comprises copies of excerpts from its annual reports to the Commission that show \$478,277 of discount on common equity recorded in Nicor Gas’ annual reports each year since 1973. However, it was not until 1993 that the Uniform System of Accounts was amended to require that only unrecovered common stock expenses were to be recorded in Account 214. Thus, it is not known whether those expenses were recovered prior to 1993. (ICC Staff Exhibit 14.0, pp. 10-11) Indeed, in Docket No. 99-0534, the Commission rejected MEC’s proposed common equity flotation cost adjustment, even though MEC had recorded the costs in Account 214. Noting that Commission rules did not require

utilities to amortize common stock expenses that were recovered through rates until December 31, 1993, the Commission stated that it could not conclude that all of the issuance expense recorded in Account 214 remained unrecovered. The Commission further stated that “the existence of this figure in the FERC Form 1 does not necessarily require that it be reflected in rates.” (Order, Docket No. 99-0534, July 11, 2000, pp. 35-36)

Second, the Company’s flotation cost adjustment calculation does not accurately reflect the costs it claims it has incurred but remain unrecovered. Dr. Makhholm’s flotation cost adjustment reflects \$4,142,661 of underwriting discounts and commissions as well as \$454,000 of estimated other issuance expenses related to five issuances, totaling \$173,364,332 of proceeds.¹⁹ However, the Company has provided no documentation to demonstrate that all \$4,142,661 of underwriting discounts and commissions were *incurred* for the benefit of Nicor Gas;²⁰ it has provided no documentation to demonstrate that the \$454,000 of estimated other issuance expenses were even *incurred* at all.²¹ Furthermore, the Company provided no documentation to demonstrate that either of those costs remain *unrecovered*, aside from the \$478,277 of discount on common equity recorded in Account 214, which, as discussed previously,

¹⁹ Nicor Gas Exhibit 21.8.

²⁰ Two of the five common stock issuances were from Nicor Inc. (ICC Staff Exhibit 5.0, pp. 40-41); 220 ILCS 5/2-9-230 would preclude the Commission from including the flotation costs from the Nicor Inc. issuances unless the Company had proved the proceeds from the issuances were used for the benefit of Nicor Gas and that those issuance were not the result of capital structure manipulation, which it did not. (Illinois Bell v. Illinois Commerce Commission, 283 Ill.App.3d 188, 207 (1996))

²¹ Why the Company relied on estimates of expenses incurred over 25 years ago to calculate its common equity flotation costs rather than actual expenses is a mystery.

the Commission has found to be insufficient for that purpose. Moreover, Dr. Makhholm calculated his 2.54% adjustment factor by dividing his \$4,596,661 total flotation cost estimate by the \$173,364,332 total proceeds for five issuances rather than dividing by the full \$648,156,000 balance of equity in the Company's proposed capital structure. Thus, Dr. Makhholm's methodology actually produces an adjustment that reflects an even higher level of flotation costs than the \$4,596,661 total flotation costs that form the basis of his adjustment, which the Company has neither demonstrated to have been incurred for the benefit of Nicor Gas rate payers nor remain unrecovered. (ICC Staff Exhibit 14.0, pp. 13-14)

F. Overall Cost of Capital

Mr. McNally's overall cost of capital recommendation, incorporating his recommended capital structure and costs of short-term debt, long-term debt, preferred stock, and common equity, equals 7.55%. (ICC Staff Exhibit 14.0, Schedule 14.1) The record consistently demonstrates that Mr. McNally's recommendations are based upon the valid application of sound financial theory, while those of Mr. Mudra and Dr. Makhholm are not. Therefore, Staff recommends that the Commission adopt Mr. McNally's recommendations, as outlined below, to set rates in this proceeding.

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	\$177,608,285	13.65%	2.58%	0.35%
Long-term Debt	\$478,311,049	36.77%	6.72%	2.47%
Preferred Stock	\$1,386,101	0.11%	4.77%	0.01%
Common Equity	\$643,607,150	49.47%	9.54%	4.72%
Total Capital	\$1,300,912,585	100.00%		
Weighted Average Cost of Capital				7.55%

VI. COST OF SERVICE, RATE DESIGN, AND TARIFF TERMS AND CONDITIONS

A. Cost Of Service Study

1. Marginal Cost Of Service Study

In its direct testimony, Nicor proposed an allocation of costs to the rates available under its tariffs based upon a marginal cost of service study (“m-coss”) presented by its witness Dr. Hethie S. Parmesano (Nicor Gas Exhibit 13.0). Dr. Parmesano suggested that rates based upon an m-coss provide three major benefits:

1. Social welfare benefits,
2. Benefits to ratepayers as a whole, and
3. Limiting or reducing cross-subsidies among ratepayers (Id., p. 5, ll. 108-114).

While the Company’s stated purposes for recommending an m-coss for cost allocation appear meritorious, Staff witness Luth explained why an m-coss is not appropriate for allocating costs when compared to an embedded cost of service study (“e-coss”) (ICC Staff Exhibit 7.0, pp. 4-6, ll. 57-101). An e-coss is more connected to the test year revenue requirement as compared to an m-coss because costs are organized according to the accounts that result in the test year revenue requirement (Id., pp. 4-5, ll. 66-75). In an e-coss, individual groups of costs are allocated to the customer classes according to appropriate cost causation or cost relationship measurements. Thus, through the detailed analysis of costs that represents test year revenue requirement, an e-coss results in an allocation of costs based upon how the

utility's system is currently used in the test year. The Commission's practice has been to allocate costs based upon an e-coss and Staff recommends its continued use in this docket (ICC Staff Exhibit 7.0, p. 4, ll. 59-64).

Nicor did not show how the cost of delivery service is marginal or will vary according to changes in use. Dr. Parmesano observed that revenue requirement is largely a function of depreciation and return on investment made in the past. (Nicor Gas Exhibit 13.0, p. 9, ll. 225-226) The cost of the already in-place plant-in-service, direct labor, and overhead, such as customer service, will not vary to a significant degree based upon a customer's usage (ICC Staff Exhibit 7.0, p. 5, ll. 82-89). As a result, a fundamental principle of an m-coss -- that costs are allocated to customer groups based upon the cost to install or replace similar equipment today, is largely irrelevant because, in general, utility plant-in-service remains in-service for many years (ICC Staff Exhibit 16.0-Revised, pp. 4-5, ll. 82-93). Unlike an m-coss, an e-coss is based upon what the costs of already in-place plant-in-service, direct labor, and overhead are, not what those costs may be at some indeterminate point in time many years from now. Accordingly, since this docket is to determine rates based upon the Company's current revenue requirement, the e-coss is the appropriate method to determine the allocation of test year revenue requirement as a starting point for designing rates (Id., p. 5, ll. 87-96).

In surrebuttal testimony, Nicor witness Harms stated that the Company will accept the use of an e-coss to determine cost and revenue allocations by rate class (Nicor Gas Exhibit 44.0, pp. 5-6, ll. 108-116). As a result, it appears undisputed that an e-coss should be used to allocate costs in this docket. However, differences between

parties to this docket remain concerning how the costs are to be allocated within the e-coss.

2. Embedded Cost Of Service Study

a. Modified Distribution Mains Study (“MDM Study”)

Nicor presented an embedded cost of service study (“e-coss”) through the direct testimony of its witness Alan C. Heintz (Nicor Gas Exhibit 14.0). The allocation of costs through Mr. Heintz’ e-coss was based, in part, upon the results of the Company’s MDM Study (Id., p. 13, ll. 249-257). Mr. Heintz explained that the MDM Study presented in this proceeding was an update of the MDM Study used in the last Nicor general rates proceeding (Docket No. 95-0219) to allocate distribution mains costs based on peak day demands. (Id.)

Staff witness Luth did not agree that distribution mains costs should be allocated strictly upon peak day demand (ICC Staff Exhibit 7.0, p. 8, ll. 151-156). At the time Staff witness Luth filed direct testimony, Nicor had not explained how the MDM Study was completed. Since distribution mains-related costs are a significant cost function in the e-coss, Mr. Luth did not accept the results of the Company’s MDM Study and did not apply the MDM Study to his e-coss. As a result, Staff witness Luth used an Average and Peak allocation factor to allocate distribution mains costs in his e-coss (Id., pp. 8-9, ll. 154-166).

In rebuttal testimony, Company witness Harms provided a more thorough description of how the MDM Study operates to allocate costs (Nicor Gas Exhibit 32.0, pp. 6-9, ll. 114-177 and p. 12, ll. 228-243). While Mr. Harms’ explanation of the MDM

Study was more detailed, it did not include specifics in describing how the base use and heat use factors were used to determine estimated peak day demand for Rates 1, 4, 10, and 11 (Id., p. 12, ll. 228-236).

Prior to Staff filing rebuttal testimony, the Company explained the relationship of base use and heat use factors in the estimate of peak day demand for Rates 1, 4, 10, and 11. Projections of peak demands by Rates 1, 4, 10, and 11 were based upon a 79 Heating Degree Day (“HDD”). Added to the Maximum Daily Contract Quantities (“MDCQ”) for rates with daily metering, peak day demands from the Company’s rate classes totaled 50,478,799 therms, or 5,047,880 MmBtu (ICC Staff Exhibit 16.0-Revised, p. 9, ll. 184-187). Nicor projects a 52,580,000 therm or 5,258,000 MmBtu system design peak day. (Nicor Gas Exhibit 44.0, p. 7, lines 153-157) To bridge the difference between 5,280,000 and 5,047,880 MmBtu, the Company allocated an additional 18.49 percent to Rates 1, 4, 10, and 11 (ICC Staff Exhibit 16.0-Revised, Schedule 16.3, column (j), “Total” lines for Residential and Commercial). The 18.49 percent increase to Residential and Commercial demands also compensated for the Company’s reduction to 30 percent of the 6,048,000 therms MDCQ for Rates 17 and 19 down to 1,830,000 therms (ICC Staff Exhibit 16.0-Revised, p. 11, ll. 224-228).

Staff witness Luth neither agreed nor disagreed with the Company’s projection of system design day peak demand, but did disagree with the Company’s demand cost allocation among the customer classes. Since the Company projected Rates 1, 4, 10, and 11 based upon base use and heat use on a 79 HDD, and other classes based upon their MDCQ, Mr. Luth explained that it is possible that peak demands for Rates 1, 4, 10, and 11 are overstated. The MDCQs as of March 31st, 2004 for rate classes with daily

metering were established based upon 2003 calendar year data (Id., p. 10, ll. 201-218). The coldest day in calendar year 2003 was only 61 HDDs. Thus, lower projected peak demands would have resulted for Rates 1, 4, 10, and 11 if based upon the same 61 HDDs that represented the coldest day for the MDCQ measurements. Plugging, or filling, the entire difference between the Company's projected system peak and the sum of the projected customer class peaks and MDCQs by adding on an additional 18.49 percent to Rates 1, 4, 10, and 11 is inappropriate because there would be no consideration of temperatures colder than 61 HDDs on MDCQ customer classes. Projected peak demands of Rates 1, 4, 10, and 11 are already based upon a 30 percent colder HDD than the coldest day upon which the MDCQs are based (Id.). Adding 18.49 percent to the calculated projected peak day demands of rate classes that are based upon a 79 HDD overweights the share of peak day demand to those rate classes, particularly when the peak day demands of MDCQ rates are based upon a calendar year with a cold day of only 61 HDDs.

Since peak demand costs are allocated through the MDM Study, it is important to recognize the importance of relative customer class peak demands. If the peak day demands of one or a few customer classes are overstated relative to other customer classes, costs allocated according to demand will be excessive for the customer classes with overstated demand and will benefit the other customer classes. It is therefore necessary to remove the additional 18.49 percent from the peak demand that the Company charges to Rates 1, 4, 10, and 11. It should also be recognized that it is unlikely that 79 HDDs will be experienced in the test year (Confidential Nicor Workpaper ("WP") (285.315)6). Therefore, Rate 17 and 19 contract customers should be charged

a greater share of demand costs in a typical year than the 30 percent of the MDCQs for contract customers would suggest based upon the likelihood that it will not be necessary for Nicor to curtail deliveries to those customers to the full extent in a typical year. Staff witness Luth's adjustment to the Company's "sum-of-the-parts" calculation of relative customer class peak demands recognizes that it is inappropriate to balance the Company's projected system-wide peak demand on the backs of Rates 1, 4, 10, and 11 customer classes by an additional 18.49 percent, when the MDCQ customer classes are based upon data from 2003, which had a coldest day of only 61 HDDs. Staff witness Luth's adjustment to relative customer class peak demands also recognizes that it is unlikely that contract customers will be curtailed to the fullest extent in a typical year because a typical year will not have a 79 HDD, as shown in the Company's own confidential workpapers in this docket (Id.). To allocate distribution mains appropriately, the MDM study should be refined to recognize the appropriate relative customer class demands resulting from Staff witness Luth's adjustments to the peak demands calculated for Rates 1, 4, and 17.

Consistent with the Commission's Order in the last Nicor general rates proceeding, Docket No. 95-0219, Staff witness Luth applied the results of his adjusted MDM Study to approximately 73.24 percent of distribution mains costs (ICC Staff Exhibit 16.0-Revised, pp. 12-13, ll. 259-262). The remaining 26.76 percent of distribution mains costs were allocated according to the share of average throughput from each customer class during the test year (Id.). The 73.24 demand/26.76 average throughput allocation represents the system load factor using Mr. Luth's "sum-of-the-parts" approach to determining relative customer class peak demands, and also represents

the Average and Peak (“A&P”) approach to allocating transmission and distribution costs, which is discussed later in this brief. In Docket No. 95-0219, the Commission applied the MDM Study in that docket to 70 percent of mains costs, with 30 percent of mains costs allocated according to throughput (Order dated April 3, 1996, Docket No. 95-0219, page 49). Thus, the demand portion of Mr. Luth’s A&P is consistent with the Commission’s Order in the last Nicor rate proceeding. In fact, when the 73.24 percent demand recommended by Mr. Luth in the current proceeding is compared to 70 percent demand from the Company’s previous rate proceeding, the A&P recommended by Mr. Luth in the current proceeding places more weight upon demand than the A&P in approved by the Commission in Docket No. 95-0219.

Although Nicor witness Heintz disagreed with the Staff adjustment to relative customer class peak demand, the Company does not object to the allocation of transmission and distribution costs according to A&P, which is similar to the approach used by Staff witness Luth in applying the results of the MDM Study (Nicor Gas Exhibit 42.0, pp. 3-4, ll. 59-79). The A&P is an appropriate method to allocate mains and associated equipment costs in general (ICC Staff Exhibit 7, pp. 6-7, ll. 102-126; and ICC Staff Exhibit 16.0-Revised, pp. 12-13, ll. 241-282). Since the MDM Study allocates distribution mains costs, the A&P should be included in applying the results of the MDM Study, as reflected through Staff witness Luth’s use of the MDM Study.

b. Coincident Peak (CP) Allocation Methodology

Between Staff and Nicor, CP is at issue in the allocation of storage costs and in the role that CP has in the development of the A&P allocation factor. Nicor neither

objects to the use of the A&P in the allocation of transmission costs, nor to the use of the A&P in applying the MDM Study to distribution mains costs (Nicor Gas Exhibit 42.0, pp. 3-4, ll. 59-71). Storage costs are allocated according to CP in the e-coss presented by both Staff and Nicor. Staff and Nicor differ, however, in how the CP should be calculated to allocate costs among the customer classes.

As discussed in addressing the MDM Study in Section VI.A.2.a above, Nicor calculated CP based upon a combination of a projection of base use and heat use for monthly metered customers under Rates 1, 4, 10, and 11, which were inflated by an additional 18.49 percent, plus the MDCQs for daily metered customers under most other rates. For contract Rates 17 and 19, Nicor reduced the MDCQs by approximately 70 percent. Staff rejected the additional 18.49 percent added onto the projection of base and heat use by Rates 1, 4, 10, and 11 customers, and limited the reduction of the Rates 17 and 19 MDCQs to 1/3rd. For the same reasons Staff adjusted the MDM Study, demand should be based upon the Staff calculation of relative customer class demand because the projection of Rates 1, 4, 10, and 11 based upon 79 HDDs is sufficient without 18.49 percent added on, and may already be overstated, relative to customer classes with projections based upon MDCQs established in a year that had a coldest day of only 61 HDDs. Since it is unlikely that a typical year will experience a 79 HDD, it is appropriate to recognize that it is unlikely to be necessary for Nicor to curtail Rates 17 and 19 by 70 percent of MDCQ. A reduction of the Rates 17 and 19 MDCQs by 1/3rd is a more appropriate measure of curtailment of Rates 17 and 19 necessitated by a cold day because, as discussed previously, it is unlikely that a 79 HDD will be experienced in a typical year. Staff's projection of relative class peak demands (ICC Staff Exhibit

16.0-Revised, Schedule 16.3, column (k)), therefore, should be used to determine the allocation of demand-related costs.

c. Average & Peak (A&P) Allocation Methodology

In direct and rebuttal testimony, Nicor proposed to allocate transmission and distribution costs according to CP (Nicor Gas Exhibit 14.0, p. 13, ll. 255-257 and pp. 13-14, ll. 265-270; and Nicor Gas Exhibit 31.0, p. 2, ll. 35-38). In direct testimony, Staff recommended the use of the A&P to allocate transmission and distribution costs, although Staff did not preclude use of the MDM Study rather than a general demand allocation factor pending further explanation of the MDM Study by the Company (ICC Staff Exhibit 7.0, pp. 6-9, ll. 102-166). In rebuttal testimony, Staff continued to recommend the use of the A&P along with an adjusted MDM Study for distribution mains costs, although Staff adjusted the demand aspect of both the A&P allocation factor and the MDM Study (ICC Staff Exhibit 16.0-Revised, pp. 8, ll. 152-282). In surrebuttal testimony, Nicor did not agree with Staff's adjustment to the demand aspect of the A&P, but did not object to the use of the A&P for transmission costs or to the application of the A&P to distribution mains costs allocated according to the MDM Study (Nicor Gas Exhibit 44.0, pp. 5-6, ll. 108-116).

The Staff recommends the use of the A&P set forth in its rebuttal testimony to allocate transmission costs and to allocate the demand portion of costs allocated according to Staff's adjusted MDM Study. Utilization of the Staff proposed A&P reflects the fact that transmission and distribution mains are used not only on a few cold days of the year, but also for the bulk of days in a given year that do not approach the peak day

(ICC Staff Exhibit 16.0-Revised, p. 13, ll. 263-282). While it is reasonable to expect that higher transmission and distribution costs result from increased capacity, no party has shown that differences in demand affect transmission and distribution costs on a demand to cost basis. Stated differently, it has not been shown that a doubling of demand capacity causes a doubling of transmission or distribution costs. Furthermore, it is obvious that the Nicor gas distribution system is used 365 days in a year, and is built to be used throughout the year, not just on a few peak days. The A&P reasonably balances the allocation of costs to provide gas distribution service not only on peak days, but throughout the year.

B. Rates, Riders, and Other Terms

- 1. Rate 5: Seasonal Use Service [uncontested]**
- 2. Rate 75: Seasonal Use Transportation Service [uncontested]**
- 3. Rider 6**
 - a. Treatment of Hub Revenues and Expenses**

(1) Introduction and Statement of Facts

Nicor's filing proposed to credit the net revenues from Hub services to the cost of gas calculations in the Company's Purchased Gas Adjustment mechanism implemented through Rider 6. (Nicor Gas Exhibit 8.0, p. 12) The Hub is the Company's transportation and storage facilities that it utilizes to provide public utility service. The Company does not utilize its facilities at 100% capacity 24 hours a day, seven days per week for public utility service. Thus, Hub Services are possible through the underutilization of existing public utility facilities. Hub services are required to be interruptible so as not to impair the provision of utility service. Hub services are often

referred to as “off-system transactions” and when the Company earns revenues from these transactions, a portion of that revenue is credited against the Company’s current revenue requirement, thus providing a dollar benefit to all utility customers, i.e., both sales and transportation customers. The contested issues concerning Hub services are related to the elimination of Hub revenue benefits to transportation customers under the Company’s proposed method of crediting Hub revenues and the Company’s proposed expansion of Hub services.

(2) Hub Revenues

Staff witness Borden agrees with the Company’s proposal to flow Hub revenues through its PGA clause, i.e., Rider 6. (ICC Staff Exhibit 8.0, pp. 3-4) Hub revenues are currently credited against base rates, i.e., there is a fixed amount of estimated Hub revenues determined in the Company’s previous rate case that was credited against the base rate revenue requirement. (ICC Staff Exhibit 8.0, pp. 3-4) The current base rate method of accounting for Hub revenues provides an incentive for the Company to provide Hub services in a manner that may result in higher gas costs to Nicor’s sales customers. This incentive occurs because the Company retains all revenue from Hub services – offset only by the fixed amount that is currently credited against the base rate revenue requirement. (ICC Staff Exhibit 8.0, pp. 3-4) At the same time, any increased gas cost resulting from the provision of Hub services is recoverable from ratepayers through the PGA. Thus, the Company has an incentive to enter into a greater number of Hub transactions and for larger amounts of money because the Company can retain all of the profit above the fixed amount currently credited to base rates. This may lead to

transactions that compete with public utility service or that result in higher gas costs to sales customers.

Adopting the Company's proposal for Hub revenues will provide greater protection for sales customers against potentially higher gas costs from Hub services, and will provide a benefit to ratepayers from Hub services that is commensurate with the provision of Hub services. The commensurate benefit to ratepayers should not be underestimated because Hub services are only possible through the utilization of facilities that are built for public utility service and paid for by public utility customers. Staff is concerned that under the Company's proposal, transportation customers will lose the benefit of the current base rate credit (i.e., operating revenue credit) for Hub revenues because the vast majority of transportation customers do not take service under the Company's PGA. The Company, in surrebuttal, indicated that it could address this concern through a credit to transportation customers via the PGA. (Nicor Gas Exhibit 44.0, p. 14, ll. 301- 308) If it is permissible to flow such a credit through the PGA (details of the proposal were not provided and such details are needed to assess its viability), then Staff witness Borden supports the Company's surrebuttal proposal. Although it is unclear to Staff how such a PGA credit will work for transportation customers, Staff encourages the Company to develop such a proposal.

(3) Hub Costs

The Company initially proposed that the cost of Hub services be flowed through the PGA. (ICC Staff Exhibit 8.0, pp. 3-4) Staff witness Borden opposed the Company's original treatment of the cost of providing Hub Services because the costs are administrative in nature and are not associated with the cost of transactions to provide

gas to sales customers. (ICC Staff Exhibit 8.0, pp. 3-4) Staff witness Borden proposed, and the Company agreed on rebuttal, that the cost of providing Hub Services shall be recovered through base rates. (ICC Staff Exhibit 8.0, pp. 3-4; Nicor Gas Exhibit 24.0, p. 7)

(4) 120 Day Term Limitation on Hub Loans

Hub Loans are transactions whereby the Company will lend or borrow gas commodity to or from third parties for repayment at a later date. Such loans are possible because, at various times throughout the year, the Company will have more gas in storage than it needs or third parties will have excess gas in their storage bank. Hub loans are primarily possible through the Company's existing storage facilities.

The Company proposes to remove the current 120 day term limitation on Hub Loans and replace it with no time limitation. (Nicor Gas Exhibit 8.0, pp. 15-20) The Company's proposal mimics the treatment of Hub Loans under its FERC jurisdictional tariff and supposedly would increase business under its ICC jurisdictional tariff, thus increasing the HUB revenue credit to PGA customers. (Nicor Gas Exhibit 8.0, pp. 15-20) Staff witness Borden opposes the Company's proposal to remove the 120 day term limitation on Hub Loans. (ICC Staff Exhibit 8.0, pp. 4-5) Mr. Borden is concerned that Hub Loans may result in higher costs to sales customers, despite the PGA treatment of Hub Revenues. Staff witness Borden believes that the 120 day term limitation serves as a protection to sales customers and should be maintained. (ICC Staff Exhibit 8.0, pp. 4-5; ICC Staff Exhibit 17.0, pp. 18 – 21)

Hub Services are intended to be provided on an interruptible, short term basis, and by eliminating the term limitation the Commission may encourage Hub Loans that

compete with the use of system gas, and transportation and storage facilities intended for firm sales customers, thus increasing costs to sales customers. (ICC Staff Exhibit 8.0, pp. 4-5; ICC Staff Exhibit 17.0, pp. 18 – 21) Staff has been unable to identify specific Hub transactions to date that have increased costs to sales customers, but rather than hope that no transactions will be made that increase costs to sales customers, Staff recommends that the Commission maintain the current short term nature of Hub transactions as a protection for public utility ratepayers.

(5) One Year Term Limitation On All Other Hub Transactions

The Company proposes to remove the current one year term limitation on Hub Transactions (other than Hub Loans) and replace it with no time limitation. (Nicor Gas Exhibit 8.0, pp. 15-20) The Company's proposal mimics treatment of Hub Transactions (other than Hub Loans) under its FERC jurisdictional tariff and supposedly would increase business under its ICC jurisdictional tariff, thus increasing the credit to PGA customers. (Nicor Gas Exhibit 8.0, pp. 15-20)

Staff witness Borden opposes the Company's proposal to remove the one year term limitation on Hub Transactions (other than Hub Loans). (ICC Staff Exhibit 8.0, pp. 8-9; ICC Staff Exhibit 17.0, pp. 18 – 21) Hub Services are intended to be provided on an interruptible, short term basis, and by eliminating the one year term limitation the Commission may encourage Hub Transactions that compete with the use of system gas, and transportation and storage facilities intended for firm sales customers, thus increasing costs to sales customers. (ICC Staff Exhibit 8.0, pp. 8-9; ICC Staff Exhibit 17.0, pp. 18 – 21) The Company has not adequately explained how Hub transactions will increase under the ICC Jurisdictional tariffs, due to migration from FERC

jurisdictional transactions when Hub Transactions under ICC jurisdiction cannot be utilized for interstate service. (ICC Staff Exhibit 17.0, pp. 18 – 21)

(6) HUB Firm Services

The Company proposed to offer firm service through the HUB. (Nicor Gas Exhibit 8.0, pp. 15-20) Staff witness Borden opposed the Company's proposal to offer HUB Firm Service on the basis that such service was likely to compete with sales service and could impair reliability and/or increase the cost of service to Sales customers. (ICC Staff Exhibit 8.0, pp. 6 – 8) Staff witness Borden further explained that given the firm storage and transportation service that is available under the Company's tariffs, there does not appear to be a need to offer HUB Firm Service and such service, if offered, may be discriminatory in nature. (ICC Staff Exhibit 8.0, pp. 6 – 8)

In rebuttal, the Company withdrew its proposal to offer HUB Firm Service. (Nicor Gas Exhibit 24.0, p. 9)

b. Commodity Portion of Uncollectibles

Staff witness Borden agrees with DRI's proposal that the portion of uncollectible expense attributable to gas commodity portion of the bill NOT be recovered from Customer Select or any other transportation customers. (ICC Staff Exhibit 17.0, pp. 13 - 15) All suppliers are exposed to risk of nonpayment and uncollectible expense and requiring transportation customers to pay for the uncollectible expense associated with gas supply portion of the bill effectively requires they pay twice and unnecessarily increases the cost to customer select suppliers. (ICC Staff Exhibit 17.0, pp. 13 - 15) Staff witness Borden proposed that transportation customers be allocated only the

portion of uncollectible expense that is attributed to the delivery portion of the bill. (ICC Staff Exhibit 17.0, pp. 13 - 15)

Staff witness Luth, allocated uncollectible expense on the basis on therms, since gas supply billings from Nicor, also referred to as sales billings, are billed according to the number of therms sold to each sales customer, Staff witness Luth in designing rates allocated Uncollectible Accounts Expense from Nicor sales billings to the customer classes according to the number of test year gas sales therms under each rate. Mr. Luth accomplished this by dividing 2/3rds of total Uncollectible Accounts Expense by total sales therms, net of Late Payment Revenues from sales billings, to obtain an Uncollectible Accounts Expense from sales billings cost per sales therm, and then multiplying that per-therm cost by number of sales therms under each rate (ICC Staff Exhibit 16.0-Revised, p. 15, ll. 306-309, and Schedule 16.4). Staff rates then recover Uncollectible Accounts Expense from Nicor gas supply billings through the volumetric charge for sales billings under each rate. Under Staff's proposed rates, Customer Select customers and transportation customers would pay less per therm distributed than their sales customer counterparts under the same rate or companion rate (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised). Because costs are combined among companion rates, the reduced volumetric rate for transportation customers is based upon Uncollectible Accounts Expense from gas supply billings divided by combined total therms distributed under the companion rates.

c. Commodity Portion of Gas Cost

d. Gas Storage Losses (2% Withdrawal Factor)

Staff witness Luth allocates Gas Storage Losses to the customer classes according to sales terms under each rate, so that the allocation to each rate is limited to the percentage of sales terms within each rate. Transportation customers would pay for gas storage losses through a lost and unaccounted for adjustment (ICC Staff Exhibit 16.0-Revised, p. 19, ll. 392-403). Sales customers pay for gas storage losses through distribution rates that include an allocation of gas storage losses.

e. Working Capital on Gas Storage

4. Rate 1

For Rate 1, Residential Service, Nicor proposes a combination of a monthly customer charge and a declining three-block distribution rate (Nicor Gas Exhibit 44.4, p. 3, ll. 1-6). Based upon the Nicor e-coss, Rate 1 revenues under the Company's proposed rates would recover less than the full Rate 1 cost of service, with \$378,037,000 in revenues (Nicor Gas Exhibit 44.4, p. 3, l. 8, column (E)) compared to a \$398,515,000 Rate 1 cost of service (Nicor Gas Exhibit 42.1, Schedule F, p. 1, l. 7, "Total" column for Residential – Rate 1).

Staff witness Luth recommends a monthly customer charge, and a slightly declining two-block distribution rate (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, ll. 1-6). Based upon the Staff e-coss, Rate 1 revenues under Staff's proposed rates recover slightly more than the full Rate 1 cost of service, with \$365,240,000 (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, l. No. 8, column (G)) in revenues compared to a \$364,603,000 Rate 1 cost of service (ICC Staff

Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, I. 7, “Total” column for Residential – Rate 1). Rate 1 revenues recovered over Rate 1 cost of service contribute to the underrecovery of contract Rates 17 and 19 cost of service. Nicor has not proposed revisions to Contract Rates 17 and 19 in this docket.

The Commission should implement Staff’s Rate 1 recommendations in this docket. There is no need to implement the higher customer charge recommended by Nicor because Staff’s customer charge, as rounded to \$8.00 from \$7.94, recovers \$185,209,000 in revenues (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, I. No. 1, column (G)), with slightly more than \$183,747,000 in customer costs under the Staff e-coss (ICC Staff Exhibit 16.0-Revised, Schedule 16.1-Revised, p. 1, I. 7, “Customer” + “Other” column for Residential – Rate 1).

The other element of the Rate 1 schedule is the distribution rate paid for therms distributed to the service address. A nearly flat, or uniform, 2-block volumetric distribution charge, as recommended by Staff, is a simpler rate structure, which promotes understandability. Staff’s distribution charges more closely mirror how demand and volume cost of service is established. It is generally agreed that greater demand results in greater capacity costs, although the cause and effect of that relationship has not been precisely measured. As a result, the highest level of demand is certainly billed through the highest volume distribution block under Rate 1 because increased usage moves the distribution billing from the first to the next blocks. If the Company’s proposed declining three-block Rate 1 distribution rates were to be implemented, the highest levels of demand would be billed at a steeply discounted third distribution block rate relative to the first two block charges which cover lower levels of

demand. Since greater demand results in higher costs, revenue recovery should mirror that relationship to the extent possible. Staff's proposed nearly flat two block Rate 1 distribution charges more closely follow this approach in allocating demand and volume costs than the Company's proposed declining three block distribution charges.

Nicor witness Harms' expressed concern that Staff's nearly flat two-block Rate 1 distribution charges add volatility to customers' bills (Nicor Gas Exhibit 44.0, p. 21, ll. 455-458). While higher usage under Staff's proposed rates will result in higher billings for distribution service, the true volatility in a customer's bill is in the cost of gas itself. IIEC witness Rosenberg noted that gas prices have more than doubled over the past few years (IIEC Exhibit 2, p. 26, ll. 3-11). Given Dr. Rosenberg's assertion that natural gas costs are approximately \$7.00 per Mcf, or 70¢ per therm, natural gas costs would have been approximately 35¢ per therm a few years ago. A 35¢ per therm difference for gas supply is more than 13 times the 2.57¢ difference between Staff's high volume distribution charge of 7.76¢ per therm and the Company's proposed high volume distribution charge 5.19¢ per therm and renders the difference in distribution charges almost insignificant.

"Volatility" is certainly a relative term. Given the context of the total bill that includes gas supply, the difference between the Company's and Staff's high-volume distribution rate can hardly be described as "adding volatility." Since Staff's recommended Rate 1 distribution charges more closely follow the method by which demand and volume costs are allocated and the customer bills would not be as volatile as the Company suggests, the Commission should implement Staff's recommended Rate 1 distribution charges.

5. Rate 4

Rate 4 is a “companion” rate with Rate 74, as well as Rates 10 and 11, which means that the rates should be similar because the rates apply to basically the same customer population. Rate 4 applies to mostly sales customers whose gas supplies are purchased from Nicor, while Rate 74 applies to mostly transportation customers that arrange their own gas supplies. As with Rate 1, Nicor is proposing a customer charge and declining three-block distribution charge for Rates 4, 10, 11, and 74, but the customer charge would vary according to meter class (Nicor Gas Exhibit 44.4, p. 3, ll. 15-23). Further since customers moving to Rates 5 and 75 are currently Rates 4 and 74 customers, when comparing revenue recovery to cost of service, newly proposed Rates 5 and 75 should also be included in revenues, even if the Company has not updated its e-coss to separate Rates 5 and 75. Thus, based upon the Nicor e-coss, Rates 4, 5, 10, 11, 74, and 75 revenues, under the Company’s proposed rates, would recover \$172,155,000 in revenues (Nicor Gas Exhibit 44.4, pp. 3, 4, 5, and 6, column (E), ll. 31, 53, 94, 117, 161, and 190). With a combined \$153,696,000 cost of service (Nicor Gas Exhibit 42.1, Schedule F, p. 1, l. 7, “Total” columns for Nonresidential – Rate 4 – General, Rate 10 – Compressed Natural Gas, Rate 11 – Energy, and Rate 74 – General Transportation), Nicor’s proposed Rates 4, 5, 10, 11, 74, and 75 would therefore recover \$18,459,000; or 12 percent, more than cost of service.

Staff witness Luth also recommends a three-level customer charge for Rates 4 and 74 that depends upon the customer’s meter class (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, ll. 15-18). Unlike the Company’s proposed Rate 4

customer charge, however, Staff's proposed customer charge allocates the increase in test year customer costs among all three meter classes, rather than increasing only the first, or smallest, meter class customer charge from current rates. The increase in test year Rates 4 and 74 customer costs over customer charge revenues at present rates should be paid by all Rate 4 customers, not just the smallest meter class as would be the result under the Company's proposed Rate 4 and 74 customer charges.

Differences between the Nicor and the Staff proposed Rates 4, 10, 11, and 74 volumetric distribution charges are similar to the differences in the Rate 1 –residential volumetric distribution charges, namely, that Nicor continues to propose a declining three-block structure (Nicor Gas Exhibit 44.4, column (D), pp. 9, 10, 11 and 74, ll. 20-22, 85-87, 108-110, and 144-146), while Staff recommends a nearly flat, or uniform, two-block structure (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, column (F), pp. 1, 3, 4, and 5, ll. 19-22, 69-71, 92-94, and 127-130). Rate 74 distribution charges are lower than the comparable Rates 4, 10, and 11 distribution charges to reflect the removal of the Uncollectible Accounts Expense allocation from Nicor gas supply billings from transportation rates in the pooled, companion rates cost of service (ICC Staff Exhibit 16.0-Revised, p. 17, ll. 349-352).

For the same reasons that a nearly flat, or uniform, distribution rate should be applied to Rate 1, the Rates 4, 10, 11, and 74 distribution charges should also be nearly flat. A nearly flat distribution charge treats each therm as being nearly the same cost to deliver and, therefore, is more closely linked to the approach taken in allocating demand and volume costs recovered through the distribution charge. Nicor's proposed declining block distribution charge structure sends the message that increased demand is less

expensive than lower demand, which is contrary to how demand costs are allocated. Since demand costs are primarily allocated according to peak demand, which represents distribution in the highest volumes of distribution charge billing, on the theory that higher demand causes higher costs, it is not logical to discount the billing in the highest volume distribution charges. As with Rate 1-Residential, the Commission should implement Staff's two-block, narrowed declining block distribution charge structure for Rates 4, 10, 11, and 74 so that demand billing more closely resembles cost allocation.

- 6. Elimination of Rate 81 – Energy Transportation**
- 7. Rate 21 – Interruptible Transport and Storage Service**
- 8. Rates 74, 76, 77, Riders 15 and 16, and Terms and Conditions**
 - a. Allocation**
 - (1) storage capacity allocation**

The Company proposes that Storage Banking Service (“SBS”) capacity be reduced from the current 26 days of MDCQ to 23 days worth of transportation customer’s MDCQ and that the critical day withdrawal rate be reduced from 2.3% to 2.1%. (Nicor Gas Exhibit 8.0, pp. 15 - 20)

In direct testimony, Staff witness Borden agreed in part with the Company’s proposal as being consistent with that approved in the Company’s previous rate case, but left the issue open pending testimony provided by intervenors on the matter. (ICC Staff Exhibit 8.0, pp. 9 – 10)

After reviewing the alternative proposals reflected in the direct testimony of IIEC/Constellation New Energy, Dominion Retail, and Vanguard Energy on this issue,

as well as the Company's rebuttal testimony, Staff witness Borden recommended that the Commission maintain the MDQ approach to the allocation of storage because it links the allocation of storage costs to the use of storage capacity at peak times and proposed in rebuttal that the SBS Allocation be based upon the historical average for the coincident peak working gas in storage ending in 2004. (ICC Staff Exhibit 17.0, pp. 8 - 12)

Staff witness Borden's calculations indicated that the three year, five year, and ten year historical averages for the coincident peak working gas in storage resulted in similar MDCQs for SBS Allocation. For rounding purposes, Staff witness Borden recommended that the MDCQ be increased from its current 26 days to 27 days. (ICC Staff Exhibit 17.0, pp. 8 - 12)

For the above-stated reasons, Staff submits that the Commission maintain the MDQ approach to the allocation of storage and that the MDCQ be increased from its current 26 days to 27 days.

- (2) storage withdrawal rights**
- (3) daily delivery algorithm/weather sensitivity**
- (4) maximum daily nomination**

The Company proposes to reduce daily nominations for transportation customers from twice the MDCQ to just the MDCQ. Staff witness Borden testified that the Company has provided sufficient justification to warrant the reduction in daily nominations. (Nicor gas Exhibit 12.0, p. 23; ICC Staff Exhibit 8.0, pp. 12 – 13) Staff recommends that the Company's proposal to reduce daily nominations for

transportation customers from twice the MDCQ to just the MDCQ be accepted by the Commission.

(5) intraday nominations

(6) upstream pipeline capacity

b. SBS Charge

Staff and Nicor are in basic agreement concerning the calculation of the Storage Banking Service (“SBS”) charge (Nicor Gas Exhibit 44.0, p. 27, ll. 610-612). When the Commission determines the base amount of cycled test year storage gas, the calculation of the SBS will be straight-forward.

Nicor witness Harms noted that Staff’s calculation of the SBS should be adjusted to allocate the cost associated with the 2% storage withdrawal factor to sales customers only (Id., ll. 594-596). Cross-examination of Staff witness Luth indicated that the 2% storage withdrawal factor is included in the calculation of the SBS (Tr., pp. 1284-1288), but cross-examination did not show that the 2% storage withdrawal factor was included in cost of service for transportation customers. Since the SBS is applied only to transportation customers, Staff agrees that, for proper separation of billing elements to transportation customers, the storage revenue requirement shown in ICC Staff Exhibit 16.0-Revised, Schedule 16.5 should be reduced by the amount of the adjustment included in revenue requirement.

Staff did not, however, allocate the cost of the 2% storage withdrawal to transportation customers because Staff witness Luth allocated the 2% storage withdrawal factor to the customer classes according to sales volumes. Demand and

volume costs allocated to transportation customers, therefore, did not include an allocation of costs from the 2% storage withdrawal factor according to transportation volumes. In Staff's rate design, revenues from the SBS reduce the revenues required from the demand charge. A reduction in the SBS to eliminate the effects of the 2% storage withdrawal factor, therefore, will necessarily increase the demand charge to compensate for the lost revenues from a lower SBS charge.

If the Commission rejects the Company's proposal to reduce availability of storage to 23 times MDCQ and increase the maximum to 27 times MDCQ, SBS billing units will increase. With increased SBS billing units, revenues from the SBS will be increased. The reduction in SBS revenues from a lower SBS charge would be then offset by an increase in SBS billing units (Nicor Gas Exhibit 44.0, p. 27, ll. 597-604).

c. Cycling

Injection Targets

The Company proposes that transportation customers' storage injections meet 90% of targeted levels by November 1st of each year. (Nicor Gas Exhibit 8.0, pp. 15-20) Failure to meet the Company's injection target results in a reduction in critical day withdrawals based on 100% of the targeted injections. (Nicor Gas Exhibit 8.0, pp. 15-20)

Staff witness Borden agreed with the Company's 90% target level for injections by November 1st as reasonable based upon the Company's actual historic levels of injections by this date. (ICC Staff Exhibit 8.0, p. 10) Staff witness Borden recommended that the critical day withdrawal penalty be based upon the 90% injection

target and not 100% of the target. Staff witness Borden explained that the 90% target should be sufficient for the penalty if it is sufficient for the level of injections, and that a penalty of this nature should be implemented gradually given that the Company has operated its system for at least 15 years prior with no such cycling or penalty provisions. (ICC Staff Exhibit 8.0, p. 11; ICC Staff Exhibit 17.0, p. 12-13)

Withdrawal Targets

Staff witness Borden opposes the Company's proposal to require a 10% target level for storage withdrawals by April 1 for transportation customers. (ICC Staff Exhibit 8.0, pp. 11 – 12; ICC Staff Exhibit 17.0, p. 13) The Company claims that its proposal is supported by the need to cycle gas out of storage so that gas can be injected for the next heating season (Nicor Gas Exhibit 8.0, pp. 15-20), but Staff witness Borden found no evidence that the Company achieves this target level by the specified date, i.e., historically this does not appear to be an actual practice of the Company. (ICC Staff Exhibit 8.0, pp. 11 – 12; ICC Staff Exhibit 17.0, p. 13) Negative HUB balances, as referenced in Staff witness Borden's testimony (ICC Staff Exhibit 8.0, pp. 11 – 12), are an indication that the Company has historically loaned system gas at this time period. Such HUB loans, if they do not result in higher gas costs for sales customers, can assist the Company in cycling gas from storage.

(1) Super-pooling

d. Level of rate increase

Nicor proposes an overall increase in revenues from Rate 76 customers. Under Nicor's proposed rates, the increase would be accomplished through a reduction in the Rate 76 customer charge, from \$474.00 per month (Nicor Gas Exhibit 17.3, p. 1, l. 51)

to \$225.00 per month (Nicor Gas Exhibit 44.4, p. 13, l. 192), a reduction of more than half, combined with a 71% increase in the volumetric distribution charge, from 1.38¢ per therm (Nicor Gas Exhibit 17.3, p. 1, l. 52) to 2.36¢ per therm (Nicor Gas Exhibit 44.4, p. 13, l. 193). Overall, the Nicor proposed Rate 76 increase would be 31.52 percent, including SBS revenues (Nicor Gas Exhibit 44.4, p. 13, l. 197, column (E) divided by ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 164, column (E)).

Staff recommends an overall increase in revenues from Rate 76 customers of approximately \$1,538,218; or 19.6 percent (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 164, column (G) compared to column (E)). Under Staff's proposed rates, the Rate 76 customer charge would increase slightly from \$474.00 per month to \$481.23 per month, the volumetric distribution charge would also increase, from 1.38¢ per therm to 1.74¢ per therm, and the SBS charge would increase from 0.39¢ per therm to 0.45¢ per therm (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 159-161, column (D) compared to column (F)). The average amount paid per therm, including customer charge, distribution charge, and SBS charge applied to maximum capacity under Staff's recommended Rate 76 would be 2.833¢ per therm (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 164, column (G) divided by line no. 160, column (C)), compared to 2.369¢ per therm under current rates (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 164, column (E) divided by l. 160, column (C)), an average increase of 0.464¢ per therm.

Nicor proposes an overall increase in revenues from Rate 77 customers. Under Nicor's proposed rates, the Rate 77 customer charge would be reduced, from \$597.00 per month (Nicor Gas 17.3, p. 2, l. 55) to \$300.00 per month (Nicor Gas Exhibit 44.4, p.

13, l. 212, column (D)), a reduction of nearly half. The Rate 77 demand charge would increase, from the current 46.33¢ per therm of demand in the first block and 1.55¢ per therm of demand in the second block (Nicor Gas Exhibit 17.3, p. 2, ll. 57-58) to 66.96¢ per therm of demand up to 10,000 therms, and 5.24¢ per therm of demand over 10,000 therms (Nicor Gas Exhibit 44.4, p. 13, ll. 214 and 215). Overall, the Nicor proposed Rate 77 increase would be 30.4 percent, including SBS revenues (Nicor Gas Exhibit 44.4, p. 13, l. 221, column (E) divided by ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 188, column (E)).

Staff recommends an overall increase in revenues from Rate 77 customers of approximately \$2,604,000; or 47.7 percent (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 188, column (G) compared to column (E)). Under Staff's proposed rates, the Rate 77 customer charge would increase, from \$597.00 per month to \$877.00 per month (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6, l. 179, columns (D) and (F)). The Rate 77 demand charge would increase, from 46.33¢ per therm of demand in the first block and 1.55¢ per therm of demand in the second block to 64.86¢ per therm of demand up to 10,000 therms, and 10.14¢ per therm of demand over 10,000 therms (Id., ll. 181 and 182). The average amount paid per therm, including customer charge, distribution charge, and maximum SBS charge under Staff's recommended Rate 77 would be 2.491¢ per therm (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6 of 9, l. 188, column (G) divided by l. 184, column (C)), compared to 1.686¢ per therm under current rates (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 6 of 9, l. 188, column (E) divided by l. 184, column (C)), an average increase of 0.805¢ per therm.

IIEC witness Rosenberg alleges that Staff's proposed increases in Rates 76 and 77 are "astounding" and a "drastic rupture from approved methodology" (IIEC Exhibit 2, p. 5, ll. 7-12). Dr. Rosenberg also warns that Staff's increases could threaten investment and jobs in Illinois (Id., ll. 18-20). While Dr. Rosenberg's hyperbole adequately makes the point that he does not favor increases averaging 0.464¢ per therm under Rate 76 and 0.805¢ per therm under Rate 77, a comparison to Rate 1 as well as gas supply costs shows that his hysteria lacks merit.

Staff's proposed rates under Rate 1 would recover \$365,240,000 in test year revenues (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, column (G), l. 8), compared to test year revenues under current rates of \$325,411,000 (Id., column (E)). Under Staff's proposed rates, Rate 1 customers would pay an average of 15.69¢ per therm (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, l. 8, column (G) divided by column (C)), compared to an average of 13.98¢ per therm under current rates (Id., column (E) divided by column (C)), an average increase of 1.71¢ per therm. Staff's proposed average per-therm increase for Rate 1 is therefore close to 4 times Staff's proposed average increase per Rate 76 therm, and more than double the average increase per Rate 77 therm (1.71¢ per therm under Rate 1 compared to 0.464¢ per therm under Rate 76 and 0.805¢ per therm under Rate 77). Thus, Staff's proposed average increases per therm under Rates 76 and 77 are considerably less than Staff's proposed average increase per therm under Rate 1. Moreover, Rate 1 customers would pay more than 5 times the average amount per therm that Rate 76 customers

would pay, and 6 times the average per therm that Rate 77 customers would pay under Staff's proposed rates.²²

Another factor to consider when evaluating Staff's proposed rates is the total cost of gas service, which would include the cost of gas supply. Staff's proposed average per-therm increases for Rates 76 and 77 are at most small when compared to increases in the cost of gas supply discussed by Dr. Rosenberg (IIEC Exhibit 2, p. 26, ll. 5-11). Compared to the 35+¢ per therm increase in gas supply costs discussed by Dr. Rosenberg,²³ Staff's proposed average increases of 0.464¢ and 0.805¢ per therm under Rates 76 and 77, respectively, for distribution are minor. If revenue recovery under Rates 76 and 77 is reduced below cost of service, other rates will have to pay more than cost of service if Nicor is to be allowed to recover its rate of return. Since Rates 76 and 77 are already the lowest cost rates per therm, other rates should not be required to subsidize Rates 76 and 77. When Dr. Rosenberg's overblown complaints about Staff's proposed cost-based Rates 76 and 77 are placed into proper perspective, it is clear that the Commission should reject those arguments and implement Staff's proposed Rates 76 and 77.

²² 15.71¢ per therm under Rate 1 compared to 2.833¢ per therm under Rate 76 and 2.461¢ per therm under Rate 77.

²³ According to Dr. Rosenberg, wholesale gas prices have more than doubled since only a few years ago. Half of Dr. Rosenberg's current \$7.00 per Mcf, or 70¢ per therm would be 35¢ per therm.

- 9. Rider 13 – Group size limitation**
- 10. Rider 16 (Customer Select) – Gas Management Issues**
 - a. storage capacity allocation**
 - b. storage withdrawal rights**
 - c. daily delivery algorithm/weather sensitivity**

The Company currently provides no daily variability in storage withdrawals within a given month for customer select suppliers, despite the fact that customer select load is weather sensitive and varies daily based upon changes in the weather. The inability to vary daily withdrawals from storage increases costs to customer select suppliers and is not indicative of how the Company uses storage to serve sales customers and other transportation customers. (ICC Staff Exhibit 8.0, pp. 13 – 15; ICC Staff Exhibit 17.0, pp. 2 - 4)

Staff witness Borden proposes that the Company provide greater flexibility in daily storage withdrawals for customer select suppliers by adopting a formulaic approach, similar to that approved for Peoples Gas' small volume transportation program, that will allow daily storage withdrawals to vary based upon forecasted changes in heating degree days. (ICC Staff Exhibit 8.0, pp. 13 – 15; ICC Staff Exhibit 17.0, pp. 2 – 7; ICC Staff Schedule 17.1)

Staff witness Borden's proposal provides greater flexibility to customer select suppliers, and is reflective of how storage should be used to meet peak demands and to provide a hedge against higher market prices for gas that are generally observed during the heating season. (ICC Staff Exhibit 17.0, pp. 2 – 7; ICC Staff Schedule 17.1) Staff witness Borden's proposal is a gradual change from the existing storage withdrawal requirements imposed by the Company because that proposal still provides a known

daily amount to the Company based upon the application of the formula to the respective customer select suppliers' loads. (ICC Staff Exhibit 17.0, pp. 2 – 7; ICC Staff Schedule 17.1)

Dominion Retail Inc (“DRI”) proposes that customer select suppliers be provided greater flexibility in daily withdrawals from storage. DRI’s proposal allows customer select suppliers to withdraw gas from storage in a given month subject to storage inventory bandwidths that establish minimum storage inventory levels that must remain in storage for a given month in the heating season. DRI’s minimum levels decrease as the heating season progresses, which reflects the actual operation of the storage fields. If a supplier’s actual gas in storage on a given day or in a given month violates the minimum levels, then the supplier is penalized by a significant reduction (at least 25%) in its daily storage withdrawal capacity. That is to say, the supplier has significantly reduced access to storage gas if it violates these parameters and must meet its customer load through market purchases. (DRI Exhibit JLC 2-1)

Staff witness Borden supports DRI’s proposal and recommends that the Commission approve the DRI proposal for customer select suppliers. Staff witness Borden believes that the DRI proposal for daily storage withdrawals is the long term solution to the problem of zero daily variability in storage withdrawals and is indicative of how the storage system is operated. However, Staff witness Borden believes that the Staff proposal is a more gradual move toward the DRI proposal. If the Commission prefers a more gradual movement in providing greater flexibility in daily storage withdrawals for customer select suppliers, then Staff witness Borden’s proposal is superior to the DRI proposal.

Finally, Staff witness Borden supports a collaborative process to provide greater flexibility in daily storage withdrawals for customer select suppliers should the Commission reject Staff witness Borden's and DRI's proposals in this proceeding. (ICC Staff Exhibit 8.0, pp. 13 – 15; ICC Staff Exhibit 17.0, pp. 2 – 7)

d. monthly balancing tolerance/penalty

Staff witness Borden supports the Company's proposal to increase end of the month tolerances for daily deliveries from 2% to 5%. (ICC Staff Exhibit 8.0, pp. 13 – 14)

e. access to upstream capacity / elimination of Aggregation Balancing Service Charge

11. Rider 25 – Demand Gas Costs

12. Rider 12 – Environmental Cost Recovery

The Company has proposed three revisions to Rider 12. The Company proposes to 1) add language to Rider 12 to allow for recovery of research and development ("R & D") costs associated with environmental remediation; 2) add the phrase "Manufactured Gas Operations"; and 3) change the basis for the interest component to be included in the reconciliation process from the Company's after tax cost of capital to the short term interest rate determined annually by the Commission (Nicor Gas Exhibit 12B.2, pp. 88 – 90). Staff recommends that the first two revisions be rejected but is not opposed to the third revision concerning the interest component.

Staff recommends that the Company's proposal to include recovery of R & D costs through Rider 12 be rejected for the following reasons:

1. R&D costs as incurred for remediation at a specific Nicor site have already been approved for recovery under the existing tariff language.
2. The USOA specifically addresses the accounting treatment of general R&D costs, and
3. The Commission has previously ruled that general R & D costs, even though they may be related to environmental remediation, must be specific to the Company's MGP sites to be considered for recovery under an environmental rider. (ICC Staff Exhibit 2.0, pp. 14 – 15, ll. 291 – 298)

First, with respect to current treatment of R&D costs, as Staff witness Ebrey testified, certain R & D costs have been recovered under Nicor's Rider but only after it was shown that the costs were incurred as part of remediation at a specific site, in the cited instance at Nicor's MGP site in Bloomington, Illinois. The costs were specific to the site and the Company was responsible to remediate in contrast to general R & D costs related to MGP operations generally. (ICC Staff Exhibit 11.0 Revised, pp. 10-11, ll. 198-204) Because such cost have already been allowed recovery through the rider where appropriate, no change is necessary.

Second, concerning USOA accounting treatment, the non-site specific R & D costs which Nicor is attempting to recover through its rider are already recoverable through base rates. These non-site specific R & D costs fit within the definition of 32.B. of the USOA for Gas Utilities which provides that the costs should be charged to Account 188 (ICC Staff Exhibit 2.0, p. 13, ll. 240-266).

Third, with respect to prior Commission Orders, consistent with the previous discussion of Nicor's R & D recoveries under its environmental rider, Ms Ebrey noted

that the Commission in the past has held that R & D studies must be sufficiently related to the investigation and analysis of site specific manufactured gas site to qualify within the meaning of environmental activities (ICC Staff Exhibit 2.0, p. 14, ll. 269-288).

In rebuttal testimony, Company witness Harms claims that “The Commission granted utilities the ability to remove costs relating to MGP operations from base rates and allowed those costs to be recovered through a rider. Ms. Ebrey’s position would not be consistent with the Commission’s decision in granting MGP cost recovery riders.” (Nicor Gas Exhibit 27B.0 p. 9, ll. 188 – 191) Mr. Harm’s testimony mischaracterizes the Commission’s Order in Docket No. 91-0080 et al. which discusses recovery of “coal tar *cleanup* costs” and “coal tar *remediation* expense” (Order Docket 91-0080 et al at 63, emphasis added) and is much more restrictive than “MGP operations” (ICC Staff Exhibit 11.0 Revised, p. 10, ll. 187 – 191). The Company also claims that the addition of the words “Manufactured Gas Operations” in its Rider 12 would allow it to recover certain costs it believes it is not currently recovering (Nicor Gas Exhibit 27B.0, p. 9, ll. 203 – 206). It is unclear how the Company is being discriminated against and just what costs the Company feels it is prevented from recovering through Rider 12 (ICC Staff Exhibit 11.0 Revised, p. 13, ll. 243 - 253).

Moreover, Ms. Ebrey testified that the addition of the phrase “Manufactured Gas Operations” only adds confusion to the current Rider 12 language (ICC Staff Exhibit 2.0, p. 15, ll. 302 – 313). Ms. Ebrey noted that the words “manufactured gas operations” already appear in Nicor’s definition of Environmental Activities and a comparison of Nicor’s environmental rider to that of Illinois Power’s environmental rider, which Nicor cites as an example of a utility being allowed to recover costs which it is not, shows that

the language is virtually identical. “[T]he only phrase that does not appear in Nicor’s own Rider language is ‘consultant and legal fees.’ However, Nicor’s Rider 12 allows recovery of incremental costs incurred by the Company in connection with environmental activities and ‘such costs include, but are not limited to, fees, charges, billings...’ As a result, Nicor has recovered both consultant (Burns & McDonnell and Black and Veatch Consultants) and legal (Mayer Brown Rowe & Maw) fees through Rider 12.” (ICC Staff Exhibit 11.0 Revised, p. 13, ll. 245-251)

Staff does not oppose Nicor’s third proposed change, the change for the basis of the interest component included in the reconciliation process (ICC Staff Exhibit 2.0, p. 16, ll. 318 – 326).

13. Rider 7 – Local Government Compensation Adjustment

In direct testimony, Nicor proposed an expansion of its existing Rider 7 to include an annual adjustment and reconciliation (Nicor Gas Exhibit 12B.0, pp. 30-31, ll. 673-687). The Company’s proposed Rider 7 would not go into effect until January 1st, 2007; more than a year after tariffs revised in this docket would go into effect (Id., p. 32, ll. 717-719). Staff witness Luth objected to Nicor’s proposed revisions to Rider 7, primarily because the relatively low level of costs recovered under Rider 7 does not necessitate continual monitoring by the Commission of 478 or more separate Rider 7’s from Nicor’s franchise agreements with different local governments (ICC Staff Exhibit 7.0, p. 18, ll. 341-350). At \$7.9 million of revenue recoveries under Rider 7, costs recoverable under Rider 7 would represent less than 4/10^{ths} of one percent of test year revenues (Id., p.

17, ll. 329-333). For the Commission to annually review and reconcile 478 or more Rider 7s, the costs involved should be of considerably more significance.

In rebuttal testimony, Nicor revised its Rider 7 proposal so that the charge would be on a per-customer basis, but did not eliminate the provision for an annual reconciliation and adjustment (Nicor Gas Exhibit 27.0B, p. 11, ll. 234-243). Staff continued to disagree with a revised Rider 7 that would allow an annual reconciliation and adjustment (ICC Staff Exhibit 16.0-Revised, pp. 17-18, ll. 356-367). In addition, the Company had not shown what its various Rider 7 rates would be (Id., p. 19, ll. 388-391). As a result, it was not possible to determine the reasonableness of the various Rider 7 rates.

In surrebuttal testimony, the Company again revised its Rider 7 proposal. The Company would separate the customer-based charge to recover local franchise fees into a Rider 2 that would not be subject to change until the next Nicor rate proceeding (Nicor Gas Exhibit 44.0, p. 38, ll. 842-862), and a Rider 7 for excess costs resulting from non-standard service requirements that would be subject to change between rates dockets (Nicor Gas Exhibit 44.10, Original Sheet No. 63.5).

The Company's surrebuttal proposal suffers from the same deficiencies as its previous Rider 7 proposals, namely, that the proposal is incomplete. Nicor provided most, but not all, of the various Rider 2 charges that Nicor calculated would be in effect until the next Nicor rate proceeding (Nicor Gas Exhibit 44.0, p. 38, ll. 846-850; and Nicor Gas Exhibit 44.9, Original Sheet Nos. 55.51-55.57). The Company has not shown how its revised Rider 2 and 7 proposals, in the form of customer charges rather than volumetric charges, would affect general rates on January 1st, 2007. The sheer number

of different Rider 2 charges applicable to the individual town listings in Nicor Gas Exhibit 44.9 makes it clear how difficult it could be for the Commission to annually reconcile and adjust a similar number of potential Rider 7 charges.

Nicor suggested three different versions of its Rider 7 proposal; first through its direct testimony, next, through its rebuttal testimony, and finally, through its surrebuttal testimony; none of which were complete. Without adequate supporting workpapers and analysis, Staff is unable to determine what effects the proposed charges would have on base rates or whether the proposed charges are reasonable. Given the relatively small, 4/10ths of one percent of test year revenues involved, the Commission should reject the Company's proposed Riders 2 and 7 because the proposal is incomplete, is sufficiently late to prevent adequate review before approval, and would unnecessarily add responsibilities upon the Commission to annually reconcile and possibly adjust relatively insignificant costs recovered under potentially 1,000 or more combined Riders 2 and 7. Nicor should continue to recover franchise fees and non-standard installation costs through base rates rather than through its incomplete Rider 2 and Rider 7 proposals.

14. Other Customer Select issues

(provide rate/rider number if applicable)

- a. Billing and gas supply administrative costs**
- b. Mailing list**
- c. Customer Select Signup (Account and Meter Numbers)**

Staff witness Borden supports DRI's proposal to require only the customer account number instead of both the customer account and meter number to authorize a

customer switch. This is not the only information required to authorize a switch, and switch authorizations can be electronically recorded, but Staff witness Borden agrees with DRI that requiring both the meter number and the account number today may increase customer confusion and lead to a greater number of failed switches or discourage customers from switching, which unnecessarily increases transaction costs to customer select suppliers. (ICC Staff Exhibit 17.0, pp. 16 – 17)

15. Energy Efficiency Programs

Staff witness Borden opposes the Environmental Law and Policy Center's proposal to spend \$38 million or alternatively \$10 million annually on energy efficiency programs because of insufficient detail regarding the programs. (ICC Staff Exhibit 17.0, pp. 17 - 18)

Staff witness Borden supports a collaborative process to determine energy efficiency programs to implement, and their costs, should the Commission determine that such programs should be funded. (ICC Staff Exhibit 17.0, pp. 17 - 18)

16. Other (provide rate/rider number)

VII. CONCLUSION

WHEREFORE, for all the reasons set forth herein, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding.

Respectfully submitted,

JOHN C. FEELEY
CARMEN L. FOSCO
JOHN J. REICHART
CARLA SCARSELLA
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street, Suite C-800
Chicago, IL 60601
Phone: (312) 793-2877
Fax: (312) 793-1556
jfeeley@icc.state.il.us
cfosco@icc.state.il.us
jreichar@icc.state.il.us
cscarsel@icc.state.il.us

June 22, 2005

*Counsel for the Staff of the
Illinois Commerce Commission*